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# LEGISLATION TO AMEND THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

## HEARING

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

COMMITTEE ON

BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

ONE HUNDRED SECOND CONGRESS

FIRST SESSION

ON

HOW WILL THE LEGISLATION AFFECT THE FOLLOWING ITEMS: (1) RATES CONSUMERS PAY FOR ELECTRICITY? (2) COMPETITION IN THE POWER INDUSTRY? (3) THE NATION'S ENERGY SUPPLY FOR DECADES TO COME? AND (4) FEDERAL AND STATE LAWS DESIGNED TO PROTECT CONSUMERS AND SHAREHOLDERS FROM ABUSES AND CONFLICTS OF INTEREST?

SEPTEMBER 17, 1991

Printed for the use of the Committee on Banking, Housing, and Urban Affairs





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# LEGISLATION TO AMEND THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

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TUESDAY, SEPTEMBER 17, 1991

U.S. SENATE,  
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,  
SUBCOMMITTEE ON SECURITIES,  
*Washington, DC.*

The subcommittee met, pursuant to notice, at 9:40 a.m., in room SD-538 of the Senate Dirksen Office Building, Senator Christopher J. Dodd (chairman of the subcommittee) presiding.

## OPENING STATEMENTS OF SENATOR CHRISTOPHER J. DODD

Senator DODD. The subcommittee will come to order.

Let me first welcome all of our witnesses this morning and welcome as well the distinguished chairman of the Banking Committee, Senator Riegle and my colleague from Alabama, Senator Shelby.

This is a little different sort of a framework for hearings, since we have so many witnesses this morning, I thought it made more sense to try and create a roundtable effect, rather than to have just opening statements and a series of witnesses, Mr. Chairman.

Let me also welcome Senator Bond from Missouri who just joined us this morning.

So to conduct the hearing in this fashion, we're going to invite a lot of informality here. Although I'll address, and members will address, specific questions to various members of our distinguished panel, I'd like others to feel free at the end of those statements, if there's something that you'd like to add or some point which you'd like to address, then feel free to do so.

This way, we can have a good and lively discussion here this morning about this legislation.

I don't think I have to tell the people in this room how much is at stake in the debate over this legislation. It has the potential, of course, to affect virtually every consumer of electrical power in this country, the rates they pay, the supply of electricity they obtain, and the reliability of the service that they receive.

Before we begin this morning, I think it's important to talk about the setting in which this committee and the subcommittee finds itself.

We call this hearing to discuss S. 1220, the National Energy Security Act of 1991, and specifically, title 15 of that legislation. That title amends the Public Utility Holding Company Act of 1935, as

everyone in this room is aware, is under the jurisdiction of this committee.

However, the legislation itself is not before this committee. Chairman Riegle and Senator Garn asked for referral of the bill, but their request was not granted. And after the bill was reported by the Energy and Natural Resources Committee, the bill was placed on the Senate calendar and now it awaits, as you know, floor consideration.

I would note that some of the witnesses urged in their testimony that this committee assert jurisdiction over this legislation. Our chairman and our ranking member have tried but were unsuccessful in doing that.

The rules of the U.S. Senate are rather clear on this point. The subject matter of the bill is predominantly in the jurisdiction of another committee.

Nonetheless, we scheduled this hearing this morning in the hope that we can add to the pool of knowledge on the important public policy issues raised by this legislation—what are those major issues?

First, how will the legislation affect the rates consumers pay for electricity? Many regions of the country remain deep in recession. Incomes are falling. And yet, utility rates, at best, have remained the same or have risen slightly. Utility bills are a significant portion of the budgets of most families. We have to do everything possible—I think everyone would agree—to keep rates down.

Second, how will the legislation affect the Nation's energy supply, not just this year or next, but for decades to come?

In other areas of our economy in our society, we have seen what happens when we fail to plant the seeds for future growth. We simply must ensure an affordable supply of power for our children and their children and for future years.

Third, how will this legislation affect the competition in the power industry?

In other areas of our jurisdiction, this committee has heard repeatedly about the need for competition, on the one hand, and the need for a level playing field on the other. We have heard it enough to know that competition is not an end in itself, but a means rather to an end. We have seen how competition generates new ideas, lowers costs, and increases supply.

But when we are dealing with a regulated industry or a situation where one segment of an industry is regulated differently from another, competition is never perfect and it is extremely hard to judge.

That brings me to the fourth question, which is how will this legislation affect Federal/State laws designed to protect consumers and shareholders from abuses and conflicts of interest?

We have a 56-year-old Federal law—the Public Utility Holding Company Act—which has worked to protect both stockholders and consumers from abuses by utility companies. That Federal law has made it possible for State regulators to do their jobs.

And so while we consider legislation that would relax that law in order to provide greater competition, it is essential that we know precisely what consumer and shareholder protections are being re-

moved by the legislation and what protections we have to take their place.

A fifth question we must ask is how will the legislation affect the financial condition of our Nation's utilities?

After all, we want our sources of power to remain strong and financially viable. In addition, we must understand how changes in the law will affect the ability of investors and regulators to assess the financial condition of these companies.

Sixth, how will the legislation affect environmental and other concerns?

It has been argued that how we structure this industry from a regulatory point of view will affect conservation efforts, the efficiency of power production, pollution control effects, and other environmental concerns.

Issues in this area rarely come before this subcommittee or this full committee, but they obviously are extremely important to every member of the U.S. Senate.

Because of the importance of these issues, my goal in conducting these hearings has been to conduct them fairly and objectively. I have not come here this morning, nor do I believe my colleagues have, with any agenda, other than to attempt to sort through the major issues and to learn from our distinguished witnesses what we have before us.

After hearing and reading the testimony, I will say the written statements of the witnesses raise a number of concerns about how the legislation impacts the major issues that I have outlined.

So my sense is that we should go slow here. There is a lot more we need to know before dismantling the current regulatory scheme. Perhaps some of my concerns will be addressed through the process of raising questions and listening to the responses of the witnesses here this morning.

However, I must add that this process has not been helped by the actions of one group involved in this debate—the Electrical Reliability Coalition. Last week, this group ran an ad in a major newspaper in my home State of Connecticut as part of what can only be seen as an effort to create hysteria over this issue, linking this legislation with everything from the problems in the airline industry to the savings and loan debacle, and label those who support this legislation as special interests somehow.

The false and misleading statements in the ad were designed, in my view, to mislead consumers about this subcommittee's power to effect legislation in this area, stating that I somehow had the power to stop this legislation.

It was a pretty blatant attempt, in my view, to bully Members of the U.S. Senate into taking positions opposing the legislation even before holding the hearing this morning.

At any rate, I'll ask by unanimous consent that the ad be inserted in the record so that my colleagues can have an opportunity to read it and to see it. It's pretty blatant and pretty foolish, in my view, as well.

Whoever had the bright idea to add that ad certainly didn't help that coalition in this Senator's eyes at all.

At any rate, on the fundamental issue of whether or not this industry should be deregulated, there are some exceptionally credible

and thoughtful witnesses here this morning who argue that it should not be, or at least that Congress should move forward only if additional safeguards are added to the bill.

There are also those who argue strongly that the legislation is in the best interests of the Nation's consumers.

The debate that we will engage in this morning is exactly the way that the process is supposed to work, not through ad campaigns or creating hysteria, as I mentioned earlier.

Anyway, let me close by returning to the basic question we need to ask this morning. If this legislation is adopted or if it fails, will the Nation's consumers and businesses get the power that they need when they need it at a cost they can afford.

I look forward to a productive morning and I'll now turn to my colleagues for any opening statements they may have.

I'll turn to Senator Bond first of Missouri. And, Kit, I apologize for not looking over and seeing you there.

Senator BOND. Please don't let it happen again.

Senator DODD. I promise I won't. [Laughter.]

I presume I'll hear about some bullying.

#### OPENING STATEMENT OF SENATOR CHRISTOPHER S. BOND

Senator BOND. I commend you for your fearless fortitude in moving forward to hold a hearing on this very difficult, but important, issue.

As you have stated, Mr. Chairman, the Public Utility Holding Company Act, or PUHCA, as some like to call it, falls within the jurisdiction of the Senate Banking Committee. Despite that fact, however, as you noted, the Senate Energy Committee included several significant amendments to the act in title 15 of S. 1220, the National Energy Security Act, which it reported out of committee in June.

You also noted the chairman and ranking member of this committee requested jurisdiction over title 15, but it was not granted, and I find this regrettable, Mr. Chairman.

The Energy Committee bill makes significant and far-reaching changes in a statute which this committee wrote back in 1935, and is reviewed periodically since then.

While PUHCA clearly affects the important energy-related issues of electricity generation, it is a significant securities law which is administered by the Securities and Exchange Commission.

For these reasons, I think the committee should have been able to review title 15 of S. 1220. This makes today's hearing by the Securities Subcommittee all the more important. It is a crucial opportunity to highlight the concerns regarding debt financing and power supply reliability raised by the proposed changes in PUHCA.

I believe, as I think most members of this committee do, that it is essential to maintain a stable financial environment for consumers and for all users of electricity, and that must be included in the deliberations as we discuss various aspects of this measure.

Finally, Mr. Chairman, I ask unanimous consent that a statement by Mark Schollander, general counsel of the Kansas City Power Light Co., be included in the record of the hearing.

Senator DODD. Without objection.

Senator BOND. I believe that it's quite helpful in understanding the perspective of many Missourians on this issue.

I thank you, Mr. Chairman.

Senator DODD. Thank you, Senator Bond.

Senator Shelby.

#### OPENING STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

Mr. Chairman, I want to tell you, I appreciate your holding this hearing this morning. This Senator didn't know about the ad in the Hartford paper and I'm like you. I deplore those kinds of tactics.

The Senate Banking Committee has had a very busy schedule this year, as we all know, and it's been difficult to turn the committee's focus onto other issues, such as we have today.

However, since the Public Utilities Holding Company Act is under this committee's jurisdiction, I think it's important that this subcommittee, Mr. Chairman, evaluate the issues surrounding reform of this law, what it means, who it's going to affect.

However, after having said that, also as a member of the Energy Committee, I can attest that the issues associated with PUHCA have already been thoroughly explored. Under the predominance rule of the Senate, the Energy Committee had that right. But we also have some jurisdiction here that I well understand.

Mr. Chairman, I thought Banking Committee issues could be complicated, very complicated, until I joined the Energy Committee. Let me say that PUHCA and the issues associated with this law challenge anything that this committee confronts in complexity and divisiveness.

The Energy Committee devoted a considerable amount of time and effort to the issues associated with PUHCA reform. Ultimately, we were able to work out some compromises that I believe most people can live with. This was not easily done.

I would compare that process to many of the efforts this committee, the Banking Committee, has undertaken in the past few years. Perhaps not everyone is happy, but, on balance, it's a deal I hope we can all live with.

I'm glad that this committee is exercising its right to examine the Public Utility Holding Company Act. I also believe that we should be extremely cautious about trying to alter any of the compromise worked out by the Energy Committee.

Each part of PUHCA reform rests in a delicate balance with the other parts and changing one provision will change the balance of the whole. We all know that. We should proceed cautiously.

Mr. Chairman, I want to again commend you for holding this hearing. I'm not going to be able to be here long this morning. I have one question that I'd like either for Charles Patrizia—I'd ask the chairman to ask on my behalf or ask for the record.

Senator DODD. I will make sure that is asked or put in the record, one or the other.

Senator SHELBY. Thank you.

Senator DODD. Senator Mack.

Senator MACK. I don't have any statement, Mr. Chairman.

Senator DODD. Mr. Chairman.



# **OPENING STATEMENT OF SENATOR DONALD W. RIEGLE, JR.**

**Senator RIEGLE.** Thank you, Senator Dodd.

Let me say at the outset in line with Senator Shelby's comments, this committee has been extraordinarily busy this year with a host of issues, many of which are still in the process of being resolved either within the committee or on the Senate floor and Senate-House conference committees.

But I want to particularly commend you, Senator Dodd, for the extraordinary amount of work that you are doing within your subcommittee. We had the hearings in that subcommittee on the Salomon situation last week, which was very complex and time consuming.

I want to just tell you from the vantage point of the full committee how much I appreciate the exceptional work you and your subcommittee are doing by pressing ahead with this part of the agenda of the committee. I'm very grateful for that.

**Senator DODD.** Thank you, Mr. Chairman.

**Senator RIEGLE.** The fact that today's hearing on the Public Utility Holding Company Act is being held by the Banking Committee may in the first instance seem somewhat strange. I think many people mistakenly believe that this legislation deals solely with energy issues.

However, PUHCA is in fact a securities statute administered by the Securities and Exchange Commission under the exclusive jurisdiction of this Banking Committee. A review of the statute reveals why.

In enacting the Holding Company Act, Congress repeatedly expressed concern for "the interest of investors in the securities of holding companies and their subsidiary companies and affiliates," and also, "consumers of electric energy and natural and manufactured gas."

As most everyone here knows, and has been stated already today, the Senate Energy Committee chaired by Senator Johnston has reported out the Energy Security Act of 1991.

That act would fundamentally amend the Holding Company Act, which is intended to eliminate corporate abuses and manipulation of the securities markets for utilities.

Senator Johnston has proposed expanding the class of companies that can generate power without triggering the registration requirements of the Holding Company Act. As Senator Dodd has stated, this committee sought a joint referral over this legislation, but that has been effectively denied.

This hearing provides the members of this committee an opportunity to consider whether the Energy Security Act of 1991 would undermine the protections of either investors or consumers of utilities.

My focus for today and for our ongoing consideration of efforts to amend the Holding Company Act is plain and simply the interest of energy consumers and customers. There are two major utilities in my State that are represented here this morning—Consumers Power and Detroit Edison. They have strongly held and differing views about the effect of pending efforts to amend PUHCA and we'll hear about that today.

While Consumers Power favors the proposed amendments, Detroit Edison, for its part, is opposed. They both contend that their position will best protect the interests of utility customers.

We will hear from these two important companies this morning and each has a highly respected executive representing them—John Lobbia, who is the chairman and CEO of Detroit Edison, and S. Kinnie Smith, Jr., who is the vice chairman of Consumers Power.

I know these gentlemen well and I welcome them to the committee this morning.

I'm also pleased that the Michigan Municipal Electric Association represented by executive vice president Gary Zimmerman, is also here to present its views. I'm looking forward to their testimony, but want to state at the outset that my approach to the issue is to ensure that customers of our public utilities have access to reliable, low cost energy.

Other issues that I believe deserve serious consideration are whether utilities provide sufficient access to their transmission facilities.

Further, I am particularly concerned that the Energy Security Act of 1991, as currently drafted, does not address the issues of cross-subsidization or self-dealing. Amendments to the Holding Company Act must ensure that companies cannot force their captive customer base to fund activities that do not directly benefit these customers.

Now I can understand why we have decided on the format that we have today, because we have a number of points of view that need to be expressed and made a part of the record and for us to consider.

But I want to make it clear that as this moves along, this committee will fully meet its responsibilities under the jurisdictional assignment of duties within the Senate. That's something that I feel strongly about. I know Senator Dodd does as well.

So, in any event, this hearing is a very important part of that process.

I thank the chairman.

Senator Dodd. Thank you very much, Mr. Chairman. I appreciate your comments.

What I'd like to do is, first of all, Mr. Chairman, and my colleagues, all the statements that have been prepared will be inserted in the record as if read in full and any supporting documentation that you care to include as part of the record as well will be included.

And then, what I'm going to ask you to do is ask each of you, beginning here on my left, to introduce yourselves and who you represent, who you're with, and then we'll begin directly with the questions.

The questions—in my own opening statement, I've sort of indicated the six areas that are sort of fundamental areas. Frankly, the purpose here this morning for us is to do more listening, in a sense.

So I really want to invite as much discussion from our panel as possible here, and I'll generate questions, or my colleagues will, and I'm going to do this in a fairly loose fashion.

So we're not going to work on a clock here. We'll just go back and forth. We're not a large number here this morning, so it can be managed. And as we move in, we'll begin frankly with probably the rates themselves. I've tried to arrange the room so that—and I want to be careful how I state this. [Laughter.]

Those on the left are inclined to be supportive of the bill, with amendments in many cases. My good friend from Connecticut, Cliff Leonhardt, is sort of the center here. On the left are sort of supporters with amendments. And to the right are those who are opposed generally. That's to say, again, there are exceptions and there are modifications along the way.

So I don't want to try and put you in too neat and tidy box as one would suggest. That will give my colleagues some idea how the room breaks down.

With that—

Senator BOND. Mr. Chairman, have you thought about having different colored caps. [Laughter.]

Senator DODD. We thought about caps and we thought about T-shirts and everything else we could have done here this morning. [Laughter.]

But let me begin with you, Mr. Smith. Why don't you tell us who you are and who you represent. And then, Paul, we'll go right to you and around the room.

**S. KINNIE SMITH, JR., VICE CHAIRMAN, CONSUMER'S POWER COMPANY, JACKSON, MI**

Mr. S. KINNIE SMITH. Good morning, Chairman Dodd, Chairman Riegle, members of the committee.

I'm Kinnie Smith, president of CMS Energy Co., the parent of Consumers Power Co., a combination gas and electric utility located in the State of Michigan.

The parent company, CMS, is an exempt holding company under the Holding Company Act.

We're delighted to be here.

Senator DODD. Thank you very much, Mr. Smith.

**PAUL ELSTON, CHAIRMAN, NATIONAL INDEPENDENT ENERGY PRODUCERS PUHCA TASK FORCE, WASHINGTON, DC**

Mr. ELSTON. I'm Paul Elston. I'm the chairman and CEO of Long Lake Energy Corp., an independent power company. And I'm also representing the National Independent Energy Producers, an association of companies like my own, and we are here in support of the PUHCA reform bill.

**TOM WHITE, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, ENRON POWER CORPORATION, LEAGUE CITY, TX**

Mr. WHITE. I'm Tom White, Senator, and I want to say that I've never sat on the left side of anything before. [Laughter.]

Senator DODD. We tried to arrange it that way for you, Mr. White. [Laughter.]

Mr. WHITE. I'm the chairman of Enron Power Corp. We're a major independent power producer, as is Long Lake, both here in the United States and internationally.

**KEYS CURRY, JR., EXECUTIVE VICE PRESIDENT, DESTEC  
ENERGY, INC., WASHINGTON, DC**

Mr. CURRY. Chairman Dodd, Chairman Riegle, I thank you for the opportunity to be here. I'm Keys A. Curry, Jr., executive vice president of Destec Energy, an independent power company located in Houston, TX.

My group elected me the offensive line for this side of the table. Senator RIEGLE. We can see why. [Laughter.]

**SCOTT HEMPLING, COUNSEL, ENVIRONMENTAL ACTION  
FOUNDATION, WASHINGTON, DC**

Mr. HEMPLING. Mr. Chairman, Scott Hempling, on behalf of the Environmental Action Foundation. We have litigated on behalf of consumer and environmental interests in a variety of Holding Company Act and Federal Power Act cases.

I would say that Mr. Patrizia and I were both surprised to find each other so close this morning, and we hope that reflects an agreement we have not yet reached. [Laughter.]

**CHARLES PATRIZIA, PARTNER, PAUL, HASTINGS, JANOFSKY AND  
WALKER, REPRESENTING AD HOC GROUP OF REGISTERED  
ELECTRIC UTILITY HOLDING COMPANIES, WASHINGTON, DC**

Mr. PATRIZIA. Mr. Chairman, Chairman Riegle, Senators, I'm Chuck Patrizia from the law firm of Paul, Hastings, Janofsky Walker. I'm here appearing on behalf of the registered electric utility holding companies. Those are the companies which are a subject of the full provisions of the 1935 act in all of its power and authority.

Mr. Hempling believes that I am here to reach an agreement with him, but actually, I am here simply to mediate between him and Mr. Doty. [Laughter.]

**JAMES DOTY, GENERAL COUNSEL, SECURITIES AND EXCHANGE  
COMMISSION, WASHINGTON, DC**

Mr. DOTY. Chairman Dodd, Chairman Riegle, I'm James R. Doty. I'm the general counsel of the U.S. Securities and Exchange Commission. And, as the Chairman has noted, among our responsibilities, we administer the Public Utility Holding Company Act.

**CLIFTON LEONHARDT, CHAIRPERSON, CONNECTICUT  
DEPARTMENT OF PUBLIC UTILITY CONTROL, NEW BRITAIN, CT**

Mr. LEONHARDT. Good morning, Senator. I'm Cliff Leonhardt, the chairperson of the Connecticut Department of Public Utility Control. Behind me and to my left is Darcy McGraw, the executive director of the department.

**GARY ZIMMERMAN, EXECUTIVE VICE PRESIDENT, MICHIGAN  
MUNICIPAL ELECTRIC ASSOCIATION, KENTWOOD, MI**

Mr. ZIMMERMAN. Mr. Chairman, Senator Riegle, Committee members, my name is Gary Zimmerman. I am executive vice president of the Municipal Electric Association of the State of Michigan.

In my role here today, I'm representing the Rural Electric Cooperative Association, also of the State. We represent about 1 million customers in the State.

In addition, I'm speaking on behalf of the American Public Power Association and the National Rural Electric Cooperative Association that serves approximately 25 percent of the U.S. population in total.

**GABRIEL STERN, DIRECTOR OF PLANNING AND PROJECT DEVELOPMENT, CONNECTICUT MUNICIPAL ELECTRIC ENERGY COOPERATIVE, NORWICH, CT**

Mr. STERN. Good morning, Mr. Chairman, Senators. My name is Gabe Stern. I represent the Connecticut Municipal Electric Energy Cooperative. I am the cooperative's director of planning and project development.

The cooperative serves five municipal utilities in Connecticut providing generation and transmission services. I'm here also today to represent the Northeast Public Power Association, representing some 70 municipally owned utilities in New England.

Thank you.

**JAMES LEAHY, EXECUTIVE DIRECTOR, CONNECTICUT PUBLIC INTEREST RESEARCH GROUP, WEST HARTFORD, CT**

Mr. LEAHY. Good morning, Senator. My name is James Leahy. I'm the executive director of the Connecticut Public Interest Research Group. We are a statewide consumer and environmental advocacy organization with about 75,000 members in Connecticut.

We also work in affiliation with the U.S. Public Interest Research Group, which has 1½ million members around the country.

**JAMES CROWE, SENIOR VICE PRESIDENT, UNITED ILLUMINATING COMPANY, NEW HAVEN, CT**

Mr. CROWE. Good morning, Chairman Dodd, Chairman Riegle, and other members of the subcommittee. My name is Jim Crowe. I'm a senior vice president with United Illuminating in Connecticut. We serve about 25 percent of the population of the State. We like to think of ourselves as the other investor-owned utility in the State of Connecticut.

**DONALD SYKORA, PRESIDENT AND COO, HOUSTON POWER AND LIGHTING COMPANY, HOUSTON, TX**

Mr. SYKORA. Good morning, Mr. Chairman. It's nice to see my Senator from my home State of Texas here. Good morning, Senator Gramm.

I'm Don Sykora. I'm president and chief operating officer of Houston Lighting Power. Houston Lighting Power is a geographically small utility located entirely in Texas. We cover an area of about a 50-mile radius of Houston, TX. We serve 1.3 million customers. We have revenues of about \$3½ billion a year, including the fuel cost.

I'm here this morning to give you something that is not a textbook theory of what happens when you have unregulated power producers in your area. We currently probably have more—we

know we have more unregulated power producers than any other utility in the country.

We have 4,800 megawatts. That is enough power to more than serve the State of Connecticut in 1989.

Senator DODD. We'll look forward to it coming up our way. [Laughter.]

**JOHN LOBBIA, CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, DETROIT EDISON, DETROIT, MI**

Mr. LOBBIA. Good morning, Chairman Dodd, and Chairman Riegle. I'm John Lobbia, president and chief executive officer of the Detroit Edison Co.

Detroit Edison is an electric-only company. We serve 1.9 million customers in southeastern Michigan. We are pleased to be able to have the opportunity today to represent those customers in front of this committee.

**SHERWOOD SMITH, CHAIRMAN, CAROLINA LIGHT AND POWER, RALEIGH, NC**

Mr. SHERWOOD SMITH. Good morning, Chairman Dodd and Chairman Riegle. My name is Sherwood Smith, chairman of Carolina Power Light Co. We serve in both North and South Carolina.

I'm also here representing not only my own company, but a group of electric utilities, including our company, Mr. Lobbia's company, Mr. Sykora's company, which form the Electric Reliability Coalition.

We are presenting testimony in opposition to the proposed amendments to the Public Utility Holding Company Act.

Senator DODD. Thank you very much, Mr. Smith.

We've been joined by two additional colleagues, Senator Gramm, Senator Graham of Florida.

Any opening comments?

Senator GRAHAM. No thank you, Mr. Chairman. I appreciate the opportunity to participate in this subcommittee hearing.

Senator DODD. Phil.

Senator GRAMM. Mr. Chairman, first let me ask unanimous consent that Senator D'Amato's statement be placed in the record as if read.

Senator DODD. Without objection.

**STATEMENT OF SENATOR ALFONSE D'AMATO**

Senator D'AMATO. Thank you, Mr. Chairman. I would like to thank you for calling this important hearing. There is no question that the electric power industry is evolving into a more competitive industry.

During the last decade, independent electric producers have grown to more than 37,000 megawatts of capacity—the equivalent of over 30 large nuclear power plants. These producers have supplied about 20 percent of all new capacity since 1978 and have brought on-line 50 percent of new capacity since 1989.

The question before us today is to what extent, the Public Utility Holding Company Act of 1935, continues to help or hinder this new era of competition.

I am no stranger to PUHCA reform. Last year, I sponsored the fourth successful amendment to PUHCA since its passage in 1935. My amendment made PUHCA consistent with the reality of increased competition in the natural gas industry. S. 1220 demonstrates that the Energy Committee is convinced that a change to PUHCA is needed to reflect the growth of competition in the electric power industry.

PUHCA, more than any other statute, has shaped the structure of the electric industry. This industry has worked well, with a proven record of reliability. We must carefully scrutinize the electric industry. While competition is emerging, we should take care not to foster unsound proposals that may in the long run lead to any additional financial burdens on the ratepayer.

Congress must look to see that in making any changes to PUHCA we emphasize that the ultimate aim is to provide consumers with a stable, environmentally sound source of electric power at the lowest possible cost.

I look forward to hearing from the witnesses today. I expect that this hearing will help shed light on whether there is any further need for PUHCA reform, and the risks of that reform, if any.

Mr. Chairman, let me take this opportunity to especially welcome Mr. Paul Elston of Long Lake Energy Company of New York City.

Thank you, Mr. Chairman.

#### STATEMENT OF SENATOR NANCY KASSEBAUM

Senator KASSEBAUM. Mr. Chairman, I am pleased you are holding this hearing today. As we can see from the interest and participation in this hearing, reform of the Public Utility Holding Company Act of 1935 [PUHCA] is a complex and highly controversial issue.

There is no dispute that PUHCA falls squarely within the jurisdiction of our committee. In my view, the proposed changes to PUHCA are too controversial and complex to be dismissed without debate and markup by our full committee. If this issue reaches the floor as part of a larger bill over which our committee has no jurisdiction, I would urge you, the ranking member of this subcommittee and the chairman and ranking member of the full committee to work to strike the PUHCA title.

In this regard, I would note the PUHCA appears to have worked well in correcting the abuses that plagued the industry in the 1930's. Before we embark on any substantial change to PUHCA, we should be convinced such changes will be in the long-term best interests of the consumers. For example, I recently noted in a Wall Street corporate financing newsletter that if the PUHCA title of the energy bill is passed in its present form it will result in a major source of new junk bond financing for the development of new energy generators.

Mr. Chairman, at a time when we are trying to digest the problems junk bonds visited upon the savings and loan industry, we should think long and hard before we act to unleash them on another regulated industry. If we allow generators to be built with substantial junk bond financing, I anticipate that consumers will

once again be asked to shoulder the burdens of excessive leverage. This may not be the case, but these are the types of issues we should look at long and hard before we give up our PUHCA jurisdiction.

#### OPENING STATEMENT OF SENATOR PHIL GRAMM

Senator GRAMM. Mr. Chairman, I want to thank you for holding this roundtable discussion.

As we all know, a major piece of energy legislation is going to come to the floor of the Senate probably in the next 2 months. It deals with many issues. One of those issues has to do with introducing private power production into the system on a more expansive basis than we've had in the past through reform of PUHCA.

We're all going to have to learn how to pronounce that, I guess, if we're going to debate it. I don't know if the sound of it is reflective of the content of the debate or not, Mr. Chairman. [Laughter.]

Senator DODD. It's called onomatopoeia.

Senator GRAMM. But in any case, I think it's very important that we hear from people who have money at stake. I always take the advice of people who have a serious investment in something.

I think that since this is under our jurisdiction, even though it's going to be debated as part of an energy bill, it's very important that we, though this hearing record will make available to people what the facts are in terms of the views of the two groups that are on opposite sides.

So I thank you, Mr. Chairman.

Senator DODD. Thank you very much, Senator Gramm.

I'm going to ask that as you respond to questions, for the purposes of our recorder here, that you identify yourself. Try to remember to do that so that our recorder will know, the record will be able to reflect whose comments.

Well I've indicated to you the first obvious question, I suppose, that we'd all be asked. While this is highly complicated legislation, and reading over the material, it is really not the subject for light reading, to try and understand the history of this. And I'm not going to pretend at all and I presume my colleagues are far more expert than I am in this—but I've tried to become at least a marginal student of the history of the legislation and what some of the issues are about that are included in the energy package. From the broad perspective, I have familiarize myself where each of you here, come down on the proposed amendments to PUHCA and how you would modify or not amend those proposals.

But the first question that comes to mind is rates. What's the effect of this in terms of the people that you serve and that we represent, by and large, here in terms of the rates they'll be paying?

I asked Cliff Leonhardt from my own State of Connecticut to go back and take a look over the last 10 years at the month of July—what has been the increases in rates, for a household using 500 kilowatts a month, the average July utility bill in Connecticut.

Now you may argue here and say, that's a terrible month to use, it's a terrible State to use, for a variety of reasons. But the utility rates rose from \$44.13 in 1982 to \$52.88 10 years later. That's a 20-percent increase over 10 years under the existing structure.



So I guess the obvious first question is how will this legislation, how will these amendments affect those kinds of rate increases?

Would we anticipate an increase of that 20 percent? Would it stabilize that 20 percent? You'd have to see some decreases in those rates.

I'll begin, Cliff, maybe with you and start. Again, I'd invite the panel here—Phil, I've encouraged the panel to jump in here and have us be more of a listening than to try and do much talking up here.

So why don't you give us some reflection on how you think these changes will affect rates.

Mr. LEONHARDT. Done correctly, with proper fine-tuning and this committee and other parts of the Congress, and over time, this legislation would reduce rates. And that is actually the reason for doing it. I mean, it's to serve the long-term interests of the American people.

Obviously, the Congress shouldn't adopt this legislation unless it did provide reliable, long-term power.

I think we're into a thing of removing barriers to entry. The purpose 10 years ago now, the small, qualifying facilities, the cogenerators. It's time to take another step to increase the role of nonutility generators. It's a big step that should be done carefully. But we shouldn't recoil from the task.

The United States is going to need the power. We have the concerns about self-dealing, cross-subsidization, and so forth. They're real, but they shouldn't be overdone.

Competitive generators—we'll monitor this and keep the States in their with their prudence review to the extent to which the markets aren't operating during a transitional phase.

Let the States look at the books and records of the EWG affiliates, and so forth. But with all these kinds of safeguards protecting to see that leverage abuses don't result in financial losses that hurt utilities, with these kinds of protections, this legislation will—not a panacea, but over time—reduce rates for the average American consumer.

Senator DODD. Let me turn, if I can, just to generate some debate because I know there are those who disagree with that, and I'll stay for the moment with Connecticut, you, Mr. Stern, you, Mr. Leahy.

Either way, in any direction, if you agree with that and if not, why not?

Mr. STERN. I think it's possibly correct and certainly correct in theory.

The concern is—I think Mr. Leonhardt spoke correctly when he said, if done right.

It's not always easy to do right. It's not always easy for regulation to act the way it should. And I think the concerns about self-dealing are real. The concern about some possible initial rate increases are real.

We've had some positive experiences I think in the past when we have deviated from PUHCA. The SEC, within its authority, took a favorable view of the formation of the Yankee nuclear companies and they were exempted from the holding act requirements. And what that meant was that when the Yankee companies would in-

crease their rates, they would flow through on the retail side and on the wholesale side.

The wholesale companies, when they're able, have done a good job of going to FERC and controlling those kinds of costs and advocating for themselves. The States have done varying jobs, in protecting their retail customers before FERC depending upon the economic climate of the State and the ability of the regulation to act in an additional forum.

So I agree that, done right, the EWG proposal can help competition, but I'm concerned about self-dealing and——

Senator DODD. You have other concerns, but basically, you agree with Mr. Leonhardt that if done correctly, this legislation could reduce consumer rates. But your concerns have to do with other aspects of this.

Is that correct?

Mr. STERN. Well, we have additional concerns which I'm sure we'll get into on transmission access.

Senator DODD. Yes.

Mr. STERN. My concern is that there not be such a euphoria if this kind of legislation goes through, that in the encouragement of EWG's which may flow from this, that there not be large temporary transitional rate increases, some of which we've seen in Connecticut with the introduction of IPP's. And that's settling down now, but there has been—one of the reasons, I think, for the increases in cost that you cited over the years on the retail side in Connecticut and over the last decade has been a timing problem with the introduction of IPP's into the Connecticut market where they came in at a very favorable time in terms of being able to negotiate with utilities, a time when long-term costs looked high, some avoided costs were high and there were some very favorable contracts granted. And for a while, Connecticut consumers are suffering because of the timing of that and some of the initial euphoria over the IPP concept.

Senator DODD. Senator Gramm just asked me a good question, Cliff, going back.

The increases in that 10-year period in the month of July, are those real dollars or are those dollars where inflation and other factors have been factored in?

Mr. LEONHARDT. I think they are not real dollars. I don't think they are factored in. I'd have to doublecheck.

But in Connecticut, the IPP's that we talked about, that's a big factor, correctly. The other thing is, in Connecticut, Millstone 3 and Seabrook coming into the rate bases, large, new nuclear facilities, they were driving those up, even in real terms.

Senator MACK. Can the Connecticut information about what those dollars represent be given to us before we conclude here this morning? To start out with that kind of information and not knowing whether it's——

Senator DODD. Yes, we ought to have that. I assumed that they were dollars that took account of that, because, otherwise, you could argue that it actually was a decrease in rates in that 10-year period without knowing exactly what else went into it.

I assumed that was the case. That's a good question. We ought to know that. Is there some way we can find that out?

Mr. LEONHARDT. Let me look here.

Senator DODD. Yes, go ahead, Mr. Stern.

Mr. STERN. I think one of the issues is—I'm sorry. I lost my thought for the moment in the interval. I'll be back to you.

Senator DODD. Mr. Leahy?

Mr. LEAHY. Senator, I think the point that Cliff and we agree on is that removing the barriers to entry and promoting true competition in the market is something that we all want because that is the way that we are going to lower consumer prices, simple economics.

Our concern, and the reason we are opposed to the proposal here today is because some of the dangers involved, we feel, with self-dealing and some of the cross-subsidization will promote a false competition, one which will allow instances of providing benefits to shareholders as opposed to ratepayers.

Those benefits are then demanded as a strategy to make the utility more financially stable. That is our concern. I think the preacquisition review and the subsequent review by the SEC is critical to ensure dealings between closely affiliated companies.

Mr. DOTY. Mr. Chairman, a point of clarification here. As an agency that is not concerned with rates, but with corporate structure and the capitalization and self-dealing of holding companies, I think it's important that we are clear in this discussion that these issues which have been raised by my colleague relate to exempt holding companies; that is to say, nonregistered holding companies.

Principally, our authority is to regulate and to govern and attend to the transactions of registered holding companies. This bill, this measure, would not significantly alter our ability, in our view, to regulate the self-dealing aspects of that.

Mr. HEMPLING. Mr. Chairman, if I may, from the standpoint of a person who litigates under the Holding Company Act and has spent a good deal of time reading and writing about it, the SEC's review of exempt holding companies, their review of those who attempt to enter the industry claiming under the banner of competition to lower rates, but actually behaving anticompetitively, is critical.

The SEC's role is not simply to protect consumers through monitoring interaffiliate transactions. The SEC role is to protect the customer when a new entrant comes to the industry.

And the fundamental change in the holding company act today authored by title 15 is to eliminate completely the entry tests for many kinds of new entrants.

Today, for example, a construction contractor like a GE or a Westinghouse cannot enter the industry without substantial review. In some circumstances, it can't enter at all.

Or a company like Consumers Power cannot at all create a new subsidiary to engage in independent power without a review by the SEC.

Mr. Doty is correct. That's not a rate review, but it is a structural review to ensure that there are not later abuses of customers.

Under title 15, we would go from total prohibition of entry in some circumstances to total permissiveness. There would be absolutely no review, and that is how the rates would be effected.

So doing it right, as Mr. Leonhardt correctly pointed out, is not a mere nuance. It goes to the fundamental question—will there be an advanced review before a newcomer enters this industry? Will there be an advanced check to see if this is the kind of competitor that actually will bring competition to the industry?

That is the review that's eliminated by title 15.

Mr. Doty. Sorry, Mr. Chairman. Jim Doty of the SEC. I'm not sure, Scott, that that dog will hunt.

First of all, the entry is still monitored in the sense that for registered public utility holding companies, the statute does not strip away all regulatory determinations to be made by the Commission. Nor does it strip away the provisions by which the commission continues to monitor the cross-subsidization and other affiliate transactions.

That remains intact. And my point here is only that there is in fact an area of utility power production and distribution, namely the large intrastate utilities, represented to our left, that is not now regulated by the SEC, and which is part of this picture.

We're dealing with this statute to the extent that powers are being limited only with respect to a limited portion of the universe of companies.

Mr. HEMPLING. I will have to correct Mr. Doty. When a registered company acquires a new EWG under this bill, there is absolutely no review. In fact, the acquisition and the resulting corporate structure is deemed to be a single, integrated holding company under title 15.

Mr. Doty. But questions of financing, questions which have typically been considered by the Commission concerning the financing structure, if there are securities issued to acquire that EWG, are not left unregulated.

The issue is shifted from whether or not the location of the generating facility results in the loss of an exemption or requires approval of the Commission. Those two issues are, as you say, resolved in favor of the utility and that we do not consider.

But the questions of the structure of the financing and the overall soundness of the utility after financing would not be taken from this Commission.

Senator DODD. Paul, why don't you—we're going to have to give the lawyers a quota here in terms of time, I think. [Laughter.]

Mr. ELSTON. And I'm not a lawyer. I think what I'm hearing is this debate about registered holding companies and about the regulation by the SEC and the nuances of that.

But it's important to keep this piece of legislation in context. It's one of many bodies of legislation that govern the situation. Namely, the Federal Power Act as well as State regulation.

I am in the process of building one of these plants. I started this by competing. When Virginia Power asked for 3,000 megawatts of power, 30,000 megawatts were offered. And the utilities sorted through those and decided that my proposal was one of the ones they wanted to buy.

For a year, I negotiated the terms of that contract and then went with that utility to the State regulators and provided tons of material for them and they examined that thing from 50 ways from

Sunday to see if it was a good deal for the ratepayers and whether we could do the job that we said that we could do.

And when we were done with that, we came down to Washington to the Federal Energy Regulatory Commission under the Federal Power Act and presented again reams of information and came under close scrutiny by them.

When I was all done with that, you'd think I was done, but I wasn't.

At that point I had to go over to the SEC. And to suggest that by removing this last step removes oversight to this process is ludicrous.

I went over to the SEC under this law and they told me I had to separate my ownership from my control. That's ludicrous, too, because it turns on its head what the original purpose of this law was.

So, keep in mind, as we're debating sort of the refinements of how the SEC works and all the nuances of it, that in the first order is State regulation and that's where this business is going to be primarily and should be primarily regulated.

Then you've got the FERC backing that up. And to say that you need yet the SEC to judge whether Long Lake Energy Corp., this 36-employee corporation in this country should be regulated by a Federal agency is on its face ludicrous.

We're talking about, through the amendment of this law, taking away that type of regulation, but only that very limited type of regulation.

Senator DODD. Let me invite the gentlemen on the right to respond to that.

Mr. SYKORA. Mr. Chairman, I'd like to go back to the original question as to what would happen to the customer rights.

Senator DODD. I appreciate that, but I'd also like to hear you respond to the point and the real-life case that Mr. Elston has just raised about, in that kind of a situation, a 36-employee firm, where you have State regulation, you've got FERC, why it would be necessary that the SEC necessarily be involved.

I think it's an important point he's raised. But I appreciate your comments on the rates as well.

Mr. SYKORA. I think I'll leave the question of the interstate—my company is not governed by FERC.

Senator DODD. Fine.

Mr. SYKORA. We're completely intrastate. So I'm going to leave that up to one of these experts over here.

If you'd like an answer now, do you want to take it, Sherwood?

Mr. SHERWOOD SMITH. Senator, I'd be glad to comment on it.

I think reference has been made in our testimony to a very comprehensive statement made by Commissioner Ronald Russell on the Michigan Public Service Commission. He's described the difficulties that that State commission has had dealing with affiliated transactions of simply an instate holding company.

The whole purpose of the Public Utility Holding Company Act was based upon disclosure and a sound capital structure to protect the public of the United States.

We think that this is a public issue. We think that the cost—if I understood Mr. Stern's response correctly, the cost in your State of

Connecticut may already be higher and rates to consumers may already be higher in Connecticut because of the purchasing of IPP power and qualifying facility power.

I know in the Carolinas, our rates are higher than they need to be because we've already been required under the Public Utility Regulatory Policy Act of 1978 to buy power that we didn't need at higher costs.

In Mr. Sykora's State of Texas, the testimony has been that his customers are paying about \$190 million a year more for their electricity than they should be paying because of what's already happened with the requirements that utilities buy from nonregulated sources.

We think it's a consumers' issue. We think that over time, costs will go up. It's inescapable that no matter how long these contracts are, if they're 10 years or 15 years, at the end of the time when those contracts expire, then you're going to have a jurisdiction that's going to be largely dependent upon nonregulated generating facilities for its energy, and instead of the public being able to buy electricity from those at a depreciated cost of service basis, it's going to have to pay what may be euphemistically called market rates or avoided cost rates, and the chickens are really going to come home to roost.

I don't think the American public is going to be very pleased with it.

Senator MACK. Mr. Chairman, if I could—

Senator DODD. Senator Mack.

Senator MACK. Let me just hop in here for a second. I just want to pick up on the comment that was made by—is it Paul Elston?

Mr. ELSTON. Yes.

Senator MACK. The series of kinds of things that you needed to go through in order to put your company into business and then get down to the end and find out that you have to go to I guess the Securities and Exchange Commission and have this reviewed, and then they made some recommendation to you—my instincts say that you shouldn't have to do that.

But there must be some reason why someone wants to take a final look from a different perspective.

What is the risk? If I were to say to you, I don't think you should go through that final step. He's gone through enough bureaucracy already to make sure that they're in fact going to be going through this properly.

Why is it necessary to take this last step?

Mr. DORT. Well, Senator, his comment is generally one that the Commission would endorse. We believe that in fact the financing vehicles and the structures which independent power producers have had to resort to in order to avoid holding company status, as explained in more detail in my written testimony, probably are not the most efficient and may in fact be inefficient ways of structuring the ownership of an independent power-producing project.

In terms of the statutes which the Commission has administered and the policies of the Holding Company Act, we would view this proposed legislation as a very conservative approach to the overall pattern of holding company regulation. It's our view that it leaves the pattern largely intact, but merely shifts to the States where

the issue properly resides the question of whether there should be an independent power producer owned by or operated by a company in that State and what the rates should be is an issue that has been said to be determined by FERC. The prudence of the contracts to be entered into with the distributor of energy would be a matter for the State authority under the legislation.

So, we do not believe that the continued case-by-case review by the staff of the SEC of the structure of these entities, to determine whether there is sufficient continuing influence and control of a project to constitute an associate or an affiliated company of a public utility, is a good use of our time or a good way to administer the statute.

Mr. ELSTON. Senator, could I just add a comment to that?

The fact of the matter is that back in 1935, this law was written at a time when 13 companies controlled something like 75 percent of all the assets in this country, the electricity assets of this country. And it was written to regulate very large, multistate companies that couldn't be regulated at the State level and that had consumer franchises. That is, they could actually tax the consumer, if you would, through their rate structure.

When it was written, it didn't envision a company like Long Lake. It didn't envision competition being a discipline in this situation.

In addition, it was written at a time when there was no State regulation that could effectively be applied in these situations.

Now you've seen most of, all but 15 percent. Basically, the assets today are owned by companies that are regulated intensely by the State. So it's a different world today.

No one ever thought that Long Lake would have to come in and take this additional step.

And the direct answer to your question, there's no risk basically if this additional step is cut out in the Long Lake situation.

Senator DODD. Let me, if I can, before we get further, make sure that we give everyone a chance on the panel, to address the subject matter. Until we get to transmission questions and so forth, the rate questions and the regulatory scheme may interest only a handful.

But also, we have time constraints. Obviously, there's a limit and there are a lot of questions. So let me take a few more minutes on this and invite my colleagues as well.

I should say, Terry, as well, we're not going to go at a normal pattern here. If you have questions based on statements that are made, just jump right in here. We're going to disregard a bit the formality that we normally have in a hearing process.

Mr. S. KINNIE SMITH. Mr. Chairman.

Senator DODD. Yes.

Mr. S. KINNIE SMITH. I'd like to respond to your rate question from the standpoint of a utility that favors PUHCA reform and the passage of S. 1220.

We find this almost inevitably to lead to better or lower rates for our ratepayers for some fairly simple reasons.

This bill presents a voluntary concept. As a utility, we can select through a competitive bidding process the lowest cost power. We

can build the plant ourselves or we can take a bid from a reliable low-cost bidder from an aggressive independent power industry.

In that way, we see rates being controlled.

An additional point I would like to make is that this bill is not a deregulation bill. All of the rate powers of the FERC to deal with wholesale rates are preserved. The rate powers of the public utility commissions are unchanged. In fact, they are enhanced.

The bill has a number of provisions which augment the State PUC powers. First of all, they expressly grant it the ability to pass on prudence so that they can join in the selection of the lowest cost power. This is consistent with the least-cost power concepts that utilities such as my company, and public utility commissions are applying.

They have also enhanced the powers of the State commission to review self-dealing transactions, to review the effect on rates of the capital structure and financing of an IPP, and also have granted broader access to books and records so that the State PUC can better police problems such as cross-subsidies and self-dealing.

I would like to respond just very briefly to the point about Michigan.

As you know, we have a large cogeneration plant, a PURPA-qualifying facility in Michigan. That plant is 49 percent owned by our parent company, CMS Energy.

There has been an allegation that the power purchase agreement was not negotiated at arm's-length. You have to recognize that the rates under that agreement have been approved and will be approved by our Commission pursuant to PURPA law and State regulations in a State proceeds.

The ownership issues have been decided no less than five times by the FERC favorably, namely that we comply with the provisions of that bill which allow us to own up to 50 percent.

We feel that those questions have been answered in a long and difficult regulatory process.

Senator RIEGLE. Mr. Chairman, would you yield at that point, as long as we're on the Michigan case?

Senator DODD. Mr. Chairman.

Senator RIEGLE. I think it would be useful to ask Mr. Lobbia because we've got another Michigan company here that has sort of the counterpoint of view, to let me hear your views so that these can be sort of juxtaposed now and in this record.

Mr. LOBBIA. Well, largely, what you hear, Mr. Senator, is a lot of speculation on how well this could go if it's done right. And I've heard three or four times "done right" here.

We have some experience with PURPA the last time we changed some provisions. Clearly, there are cases, and Houston is mentioned in here, California, Connecticut, I believe we also heard a little bit where "from the consumer's standpoint," it was not done right, that there are excessive costs up front being borne by those customers in those areas.

I go farther and say, here is an example in Michigan where we already have a project, very significant, 1,200 megawatts, under the current laws.

Mr. Elston mentioned that Virginia Power went out for 3,000 megawatts and 30,000 megawatts was bid under current law.



It seems to me that those systems are working all right. I'm sorry that Mr. Elston as one small person has to go to the SEC at the end. But the history of this business is that there are not many 36-person companies out there. There are a few today trying to carve out a niche in the business.

Our concern is not the 36-person companies. Our concern is the major players, the same people who built these powerplants before and sold them to the utilities, the same people who supplied the equipment to the utilities for these powerplants before, the same fuel suppliers who supplied to the utilities before, now coming into the business.

And they are not small players, as evidenced by that 30,000 megawatts that was bid.

There's plenty of room in the system today, albeit, difficult and complicated, as all the Senators mentioned this morning, for entrants to come into the business if they can truly afford some benefits to all the customers in the business over the long term, not just a short-term benefit provided by a financial structure that gets a cost advantage up front, but long term.

This industry is extremely capital intensive. It is one of the last healthy industries in this country in terms of its capital structure. I think that's why we're in front of this committee, because we see a lot of this as an attack on the capital structure of this industry—using the strength in this industry to lever up, to then have cost effective projects to come back and compete with those who have been in the business so long.

Senator RIEGLE. Could I—if the committee would indulge me just one more moment.

We've got a third witness from Michigan, Mr. Zimmerman, could you perhaps add your comments and either react to what Mr. Smith has said or what Mr. Lobbia has said and fill this discussion out a little bit from your vantage point?

Mr. ZIMMERMAN. It's my pleasure. Mr. Smith, I read his testimony last night and was quite surprised by some of the views he took in having the background and knowledge of how the company has structured itself in the recent years.

First of all, it has set up a complex structure of organizations that formed a holding company in 1985, currently has approximately 60 subsidiaries to that company.

The Michigan Public Service Commission has testified, I believe before Representative Sharp's committee, that it does not have adequate authority to review and screen all of the books and interactivities of this structure of affiliates that have been set up.

The cost that Mr. Smith mentioned under PURPA, the Michigan Public Service Commission went through a hearing process to establish PURPA rates which were required by Congress. These rates were set fairly high at that time, approximately 6 cents.

No one ever envisioned a privately held, investor-owned company setting up a qualifying facility in the size of 1,200 megawatts when they developed the language on PURPA. It was to bring in people like Mr. Elston.

Now the question is about rates. You go to rates, then, what were the rates?

Well, the public service commission, if this is a QF, and that's decided by FERC, not the State commission. So now we have multiple jurisdictions that play, increases another level of complexity in the decisionmaking.

FERC has decided that it is a QF, and properly so, according to the rules. But not without extensive litigation.

The interveners in that have had to pay a tremendous amount of money for lawyers, for consultants, for the time that's required on staff to go through this hearing process.

We must stop the ability of investor-owned utility companies to own and deal with their own affiliates for EWG's. And I would say that—it would only add cost to the customers. We have the hard cases in Michigan to show that. The history has absolutely shown that. And there is not adequate regulatory oversight.

As a matter of fact, one reason for the vacuum here, as PURPA was created in 1978, there was no equivalent control at the State level.

Right now, if you're going to modify PUHCA, you're going to leave a vacuum in the regulatory arena because there is no one jurisdictional body that has the responsibility to oversee the EWG's.

Senator DODD. Let me go to Senator Gramm for a minute.

Senator GRAMM. Mr. Chairman, I get lost in all this regulatory paperwork stuff. I'd like to try to go back to some first principles of this issue.

Let me just give you a brief, thumbnail sketch of how I see this history. I think what we really need to know boils down to two questions.

First of all, we made a decision in adopting PUHCA that power generation was a natural monopoly. That was not an unusual conclusion since in 1932, 67 percent of the electric power in the United States was generated by eight companies.

Because power generation was deemed to be a natural monopoly, the Government set up all these hurdles for people, hurdles addressing self-dealing, as well as capital requirements. We did so recognizing that as a natural monopoly, we had a right to set all of these conditions, and basically, American power generation has evolved under that process. Until recently, we've had few changes.

I don't think anybody here is arguing that we have done a bad job. My guess is electric power in real terms is cheaper today than it was 20 years ago.

The real question is, can it be improved? May I say that Depression-era legislation, in my mind, is always suspicious. I view it with suspicion because it was an era of basically bad economic thinking, almost uniformly. Not just here, but around the world.

So, as I see it, there are only two questions that are relevant to this issue. One is, in 1991, is power generation a natural monopoly? Is it something that should be undertaken and controlled by one company, and can that one company do it more efficiently than competition could do it?

If that's not true, the whole logic of PUHCA collapses, in my opinion.

The second issue is, if it is not a natural monopoly, then should a company that does not have a natural monopoly, that does not have a guarantee that it can sell its power to a specific locality,

that is engaged in fact in competition, should that company be required to meet all these requirements that we have set for a natural monopoly?

Now in my mind, those are the two relevant questions. And depending on how those questions are answered, either this is a case where competition doesn't fit or we're debating Perestroika.

And so I'd like to throw out the two questions. First, is power generation in 1991 a natural monopoly? And then, second, if it is not, should people who are engaged in competitive power production have to meet all these requirements that were set in 1935 for companies that were going to have an exclusive right to sell power?

And since everybody else has done it, let me begin by letting my Texans respond. [Laughter.]

Why don't I begin—I'll just start on the left with Tom White.

Mr. WHITE. Thank you, Senator.

I think it's quite clear, particularly since 1978 with the PURPA Act, that in this day and age, that there should be no natural monopoly on generation.

The utilities have no corner on the ability to build safe, cheap, reliable plants that operate under long-term power purchase contracts to the advantage of ratepayers. And I think that's been proven clearly here and it's also been proven in the United Kingdom, where you have a totally open, competitive market in the generating side and where we do a lot of business.

Now given that you agree with that, I think the second point—that is, to inflict upon people that do not have market control, that is, we don't sell to retail customers and we don't have transmission wire control—to inflict on them the same rules that monopolists have to play the game by, doesn't seem to me to be a fair or a prudent way to structure the industry to see that the ratepayer gets maximum advantage from the competition.

So I think that the answers to those questions are fairly obvious.

Senator GRAMM. Let me first say that I don't necessarily agree. I don't know what the answer is, but it seems to me that those are the two questions.

Mr. Curry.

Mr. CURRY. Yes. I would like to also say that my answer to the first is no as well. I think the independent power industry has demonstrated very clearly that it can build safe, reliable powerplants.

I think to sum up what a lot of people have said here is let's do it right. Well, what does do it right mean?

In my mind, that means that we need an increase in the number of people that are competing to sell that power. In my mind, that means that no competitor is unfairly disadvantaged or advantaged. And that ties in with some of the pretzelliike, PUHCA pretzelliike efforts that independent power has to go through to compete.

And finally, we need no discriminatory denial of access to our highway to get our power to the marketplace. And I think that results in lower consumer rates.

And a couple of specific examples are that if we overrun the cost of a plant, we the developer eat that cost. Typically, the contracts that we have with utilities in Texas and California do not pay us unless we produce.

For example, we had an explosion in a chemical plant where we provide steam, the Arco chemical plant. We were interrupted, our power was interrupted because of the explosion. We got the plant back in 2½ weeks, but that was not considered a force measure.

Under our contract with the utility, we were penalized in terms of the price we receive for that power until we can build back up and show that we have the power reliably.

So I think what we're saying is that there are three things that are necessary to make this work properly and eliminate a lot of the convoluted efforts we have to go through today.

Thank you.

Senator GRAMM. Mr. Sykora, let me give you an opportunity to respond.

Mr. SYKORA. I take the opposite side of the question. I think that power generation is a natural monopoly. I think it's been proven in this country.

Now, Tom, you know darn well that England has only been open access for less than—how long? Less than 2 years, isn't it?

Mr. WHITE. Year and a half.

Mr. SYKORA. Year and a half. They have no history over there.

Now we do have a history here. We have a history of what happened with well-intended legislation called PURPA. And what happened in our service area, our customers are paying \$190 million a year more than if we would have been allowed to build the same plants because we were not allowed to. We forget about the Fuel Use Act of 1978 that legislated that gas would not be used for boiler fuel after 1990. We were not allowed to build those plants. Plus, we're talking about two different, entirely different things. We're talking about baseload fuel diversification, the more plentiful fuels in the State of Texas.

Now, Keys, I appreciate your bringing out the real agenda here. The real agenda here doesn't have anything to do with power generation specifically. It has to do with mandatory access to transmission.

That is the agenda that is trying to be realized by this reform of PUHCA.

But we do have a history. Would anyone argue that PURPA was not well-intended legislation? I don't know how to argue a hypothetical question of what's done right. I never met anyone that went out and said, I'm going to go out and do a bad job.

I don't know how to argue that question. But I can tell you this, that it was very quick for the entrepreneurs to find the loopholes in the PURPA and along with the Fuel Use Act, to do some handsome profiteering out of the cogenerated power business.

I think that the system that we have today is the finest in the world. I don't think anyone would argue with that. It seems to me like, at the very least, a lot more study would be required to determine if there were any changes needed. And why fix it if it's working so well?

Thank you.

Senator DODD. I want to have Jim Crowe respond and answering this question as well that's been raised.

Mr. CROWE. Thank you, Senator Dodd.

Senator Gramm's perspective on this thing is in fact a useful way of clearly looking at this issue.

I'd like to address those two questions and then add a corollary question which I think is really the crux of the issue.

Yes, I think the generation of power can be a free market situation. I think the key to that is can we deal effectively with the transmission access requirements to make it truly a competitive and free market, the building and production of electricity.

Senator DODD. Jim, just on that point. We should make it clear that the Johnston bill, and Senator Johnston has been rather clear on this, does not wish to address the transmission access issue at all in the legislation.

Mr. CROWE. That's right.

Senator DODD. So it's interesting to hear about it and talk about it, but the legislation doesn't address that.

Mr. CROWE. I think it's got to come. I think some things that are going on on the House side are more in tune with the transmission requirements.

But in order for it to be a true competitive market, you have to address the transmission. And the question therein is what cost are we paying when we deal with the very sophisticated—the electrons are going to go where the electrons want to go, not where we tell them to go by law. And there are some very, very serious implications of fooling with that transmission system.

If we can fix the transmission access without jeopardizing reliability, your first question is, yes, we can make it a truly competitive market. And I think there are opportunities for doing that. And theoretically, under that regime, consumers should benefit in a competitive situation.

The second part of the question is do we need to impose on these—given the right answers to the first part, do we need to impose on these players the kind of regulatory review?

I think the corollary question here is the decision to purchase a free decision, or should it be a free decision?

Certainly, in a free market, you don't—

Senator GRAMM. What kind of decision?

Mr. CROWE. The decision to purchase. The consumer, the individual residential, business, industrial owner does not make the decision to purchase in this free market. That decision is made for him through complex regulatory utility processes, the interrelationship, the power planning process at the utility level and the commission level and the siting council level.

I think that is really the key issue. Should we just allow the consumers to be making these decisions in a free market basis? What are the long-term implications of the reliability of the power supply?

In the past, utility planning has taken into consideration security and balance of energy sources and location of energy sources, the basic financial structure underlying that industry.

When or if we make a decision to purchase on the free market our energy sources, we have to address those issues. And we would support PUHCA changes that address those issues properly.

Unfortunately, we're coming out of an era of PURPA—you've heard some of the PURPA abuses. I could go on for the rest of the

day about some of the improper decisionmaking we made which has cost customers money to purchase mandatory purchase requirements under PURPA.

So there's a natural suspicion of the industry that there will be tampering in this free market and that the tampering will not necessarily be good public policy at all times.

I'll just give you one example right now of tampering.

The Massachusetts commission has ordered one of the utilities out there to go out for bid for independent power and QF power, and utility bids have been excluded. And that's tampering. There's some kind of social agenda there.

I think the mandatory purchase at 6 cents in New York and in other States, I think history has shown that that's way above avoided cost. We've experienced that kind of thing in Connecticut.

So I think it's the purchasing decision that we've got to talk about and whether we should just leave that—I think we have to control that purchasing decision of what will get purchased and what's in it, in terms of the long-term ability to serve our customers.

Senator DODD. Kit Bond wanted to raise some questions.

Senator BOND. Mr. Chairman, actually I have a question. The first question would be for, I guess, Mr. Smith, Mr. Lobbia, Mr. Sykora. It picks up on something that Mr. Crowe just mentioned.

Gentlemen, in your testimony, you've raised the question about the 50-percent equity. I would like to know why that is a significant difference between you and the IPP's and why, if you were to contract with the IPP's for power, why you would not be able to include in your contract protections against the dangers you cite of degradation, decapitalization, and risk without compensation?

What's the problem and why can't you deal with it in a contract?

Mr. SHERWOOD SMITH. Senator Bond, I think your question raises two very important points. The first one is the proper use of leverage.

I think we've all seen that the improper use of leverage in our society can lead to excesses which will cause the industry that's serving the public, whether the airline industry, the thrift industry or, in this case, the electric power industry, to be burdened with debt and to take advantage of the tax deductions that are available for interest payments and have structures that do not have simply enough capital in them to sustain their operation on a sound fiscal basis over the long term.

The use of debt in the IPP situation is simply obvious to anyone who's looked at any of these transactions. In some cases, it's not been just 90-percent debt. It's been 100-percent debt.

That means that two things happen. The entity, the IPP is financed basically with the credit of the utility because it's only the long-term purchase contract of the utility that enables the IPP to get financing. This has been identified by the rating agencies and by others as a financial burden similar to long-term debt and leases on the utility.

It has the effect of reducing the credit worthiness of the utility, the effect of increasing its debt and its capital structure, and over time, is going to increase the rates that the utility will have to pay

for capital and the rates that it will have to charge its customers for service.

We think that, insofar as the contracts between the utilities and the IPP's are concerned, and these may vary widely from one location to another, but essentially, they're contracts that mandate payment by the utility. They're take and purchase contracts.

Those contracts may be required of State regulators based upon the apparent short-term lower costs of a small, fully financed facility.

It's been estimated that the cost initially could be 5 or 10 percent less. State commissioners may be induced to require utilities to enter into those contracts. Because of the apparent short-term advantage, it's our opinion that, over the long term, the rates are going to go up and that the whole utility system is going to be disadvantaged.

We do think that utility generation is principally a natural monopoly. A professional economist here might use the word "idiosyncratic," that the capital, once devoted to an electric generating plant, can't be used for any other purpose.

If you want to look at whether or not the industry is and should be regulated as a natural monopoly instead of in some other way, you don't need to speculate on it at all. All you'd have to do is look at what's already happened around the United States under the Public Utility Regulatory Policy Act and you can see, particularly in Texas and California, where the situation has been egregious, you've seen that the change in law and the tampering, that was Mr. Crowe's word, by the Government in this situation, has led to building excessive, unneeded facilities and forcing the public to pay for it, because rates in California and Texas paid by electric consumers are higher because of actions of the U.S. Congress than they otherwise would be.

Mr. ELSTON. Mr. Bond, since the question wasn't answered, which was, if you have a problem, why can't you do something about it, I'd like to answer it.

Senator BOND. Well, let me ask you a question and then both sides can discuss it because I was going to address one to you and Mr. Smith and Mr. White.

And that is, if everybody has access to the same architecture, engineering, and the same scientific knowledge available in the field, you could both get a turnkey plant. What is it, other than the fact that, as the gentleman on this side has pointed out, that you have advantage of having a more highly leveraged opportunity and they perhaps have a disadvantage of certain of the regulatory constraints which are not market constraints, that you could do a better job.

And I would like you to discuss your response in light of that question and maybe we can have comment from the others as well.

Mr. ELSTON. I think the fundamental principle that you've got to keep in the front of your mind here is that this legislation doesn't require anybody to buy any electricity from anybody else. It's enabling legislation.

If Mr. Smith doesn't like the contract that I offer, he says no. To go back and talk about PURPA, which has a mandatory requirement, is to talk around the subject. This is voluntary legislation. It

doesn't require anyone to buy. It doesn't require any utility regulatory to buy and it doesn't require any utility executive to buy.

They'll only buy if I come forward and offer them a good deal, a deal that they think is good for their ratepayers and their shareholders. And we've seen plenty of evidence in this country, some 13,000 megawatts have actually been purchased because utility executives have looked at the offers that were put on the table and they've said, this is a good deal for the consumer and this is a good deal for my ratepayer, and therefore, I'm going to buy it.

Now you ask, why can we do something better than the ratepayers? You ask me why the Soviet Union hasn't worked as an economy, which is the command and control without the profit incentive.

That to me is right at the essence of your question here. We're talking about profit incentive. I don't make a buck unless I deliver a product.

The problem with the cost-plus system is that if they build, they get their costs back and they get a profit on top of it.

Now I think this country has been built on the free enterprise system and it's why we're so efficient. There's very clear evidence on the fact that you can take this free enterprise concept and now bring it into the electricity industry and that it can work there as it's worked in the rest of this world.

It's ironic to me that the rest of the world now has recognized the bankruptcy of this communistic approach in the Soviet Union, and yet, we have in this country—I have utility executives talking about me as being greedy because I want to make a profit, as though they don't want to make a profit.

Now the truth of the matter is that the free enterprise system with a profit motive that will only pay if you deliver is where the efficiencies are going to come in the long term.

The rest of the details can be argued out. The fact is if you look at what FERC has said, if you look at what a whole bunch of different studies have said, the cost of capital, of independence, is no different—some say it's a little bit higher, some say it's a little bit lower. It's at least argumentable whether the cost of capital of independence is lower than that of utilities.

But the fact of the matter is it is a more powerful force that we're talking about here. It's competition and the free enterprise system.

Senator BOND. So, Mr. Elston, your answer to my question is, yes, there are financial and other regulatory constraints that puts them at a disadvantage. And to carry your analogy further, we ought to take the constraints off of the utility companies and let everybody go at it.

That is the logical extension, is it not? [Laughter.]

Mr. ELSTON. The utilities are given an exclusive franchise to serve a consumer that no one else can do. And there's got to be regulation of that. That is truly a monopolistic business and that part of the business should be kept closely regulated.

It's a ticklish business to make sure that the interface of a monopoly with the free market system is done properly. We have always advocated strong regulation on that interface. But it doesn't



mean that you shouldn't bring the benefits of free enterprise to the generation sector where we've clearly demonstrated it's possible.

Mr. PATRIZIA. Senator, I'd like to add to what Mr. Elston has said because I think there are several issues that need to be addressed in that context.

The first problem is that if electric generation is no longer a natural monopoly, it is because the remainder of the system, transmission and distribution system, still is a natural monopoly because it meets all the classic economic definitions of a natural monopoly.

There are huge economies of scale in building only transmission lines in a particular place. Duplication of those lines is both economically inefficient and very burdensome on ratepayers.

So if generation is now not a natural monopoly, it is only because the system has already been constructed to permit the distribution and to permit the transmission.

For those who say that what we need to make the generation sector work on a free market basis is access to transmission, what they're really saying is we want the ability to take advantage of that system without paying the costs of that system. And there's a problem with that.

The second point that has to be made is that if, in fact, the electric generation sector is now no longer a natural monopoly, and if it is available for competition, then that competition must be open to all. We cannot create a privileged few. We cannot create niche marketers to go out and have privileges in that system that no one else has.

The principal flaw in PURPA was precisely that it created niche marketers, a privileged few with a mandatory right to require a utility to purchase.

If we're going to have competition, everybody has to be able to compete on the same basis.

Senator DODD. Senator Sanford?

Senator SANFORD. Let me go back to the capitalization of these pieces of the industry. I have, as you know, Mr. Chairman, for a long time complained about leveraging of corporations and takeovers and that kind of capital formation.

It seems to me, from what Sherwood Smith said, that one of the reasons that the PURPA companies can be more effective or cheaper, if indeed they are, is that they're so heavily leveraged that they don't have the investment in capital.

And I carry it one step further and ask you this question.

Is this not a case of being subsidized by the taxpayers because of interest rates, that they take the deductions and we're paying it all over. We're paying a subsidy to a company that's that highly leveraged.

Mr. SHERWOOD SMITH. In my opinion, yes, Senator, that is what happens. And you could take any assumption that you wanted to make with a lump sum of dollars. Let's assume \$1 billion is going to be invested, and that \$1 billion will go into electrical generating facilities.

If 50 percent of that \$1 billion represents equity capital, that's going to require a return that will be sufficient to pay the taxes.

If, on the other hand, it's all debt, you're going to have a tremendous decrease in taxes and, indeed, the losses to the Federal Treasury and to State Governments could be significant.

Senator SANFORD. Well, now, do we have any calculations on that, how that works and how it works in the long run when presumably that debt is paid off?

Mr. SHERWOOD SMITH. That certainly could be provided. And if I may, I'd like to provide something for the record.

Senator DODD. Without objection.

Senator SANFORD. Well, I wish you would. Now let me go back and ask you a question that early on was questioned, was disputed.

I understood you to say that you have to pay more for electricity than it costs you to generate it.

Mr. SHERWOOD SMITH. Yes, that's correct. In the two Carolinas now, we're buying electricity that we don't need at higher prices than we can generate the same electricity for simply because of what happened because this U.S. Congress enacted the Public Utility Regulatory Policies Act of 1978.

That was well-intended legislation, but it was misused and particularly misused in California and Texas.

Senator SANFORD. Well, I've just heard it said that you don't have to buy this if you don't want to.

Mr. SHERWOOD SMITH. I think that reference would be to what is now being proposed under the amendments; that is, title 15. That the qualifying facility rule under PURPA which mandates that the utility must buy, would not be a part of these amendments.

But instead, you would have a framework of incentives applied by local commissions—that is, State commissions—that, in my opinion, would achieve the same result. And you can look around the country and see that. You can see that in the State of New Jersey, a number of years ago when the State commission turned down a very attractive, low cost purchase from a neighboring utility in favor of mandating purchases from privately owned, nonregulated IPP's.

Mr. Crowe has just described a situation in Massachusetts where that State commission, for whatever reasons, has decided to seek nonregulated generation facilities to be built in that State.

Now those commissioners are unlikely to be in office when those contracts expire and when the chickens come home to roost and when market prices, whatever those may be determined to be, will be applied in the future.

And if I were one of those commissioners, I certainly would not want to be in office at that time.

Senator SANFORD. Well, I fail to see how the consumer is favored by this legislation.

Mr. SHERWOOD SMITH. The consumer, in my opinion, is substantially disadvantaged by this legislation.

Senator SANFORD. I'm glad to be getting rid of you Communists, you understand. [Laughter.]

Mr. SHERWOOD SMITH. Yes, sir. I don't think this is a Marxist-Leninist forum.

Mr. S. KINNIE SMITH. Senator, I would like to address the issue of excessive—

Senator SANFORD. Yes, right here.

Mr. CROWE. Senator Sanford, I think that, unless you fix these kinds of abuses or tampering temptations, that the consumer can be disturbed by this kind of legislation.

Just take the equity, the capital structure, for example. It's very appealing to me as an argument. We've been frustrated over the years as electric utility executives and planners that, probably emotion more than anything, but we don't feel that risk and reward have been balanced. And particularly the last 10 or 15 years through these large construction programs, some of which have gone awry.

We feel that, typically, we've had more risk and regulated returns and therefore, less reward.

So the appeal on the surface of an unregulated power production system is to get the risk and reward, the risk and return system in balance.

But unless you put some protections in there, and certainly, we've addressed the return side of it. The unregulated entities are typically looking at 15, 20, 25 percent return.

I think in the past, some of them have made far in excess of that. I think through competitive bidding, that is diminishing. That opportunity is diminished.

So they address the return side of this thing. I think we need to address the risk side of it. What are we buying when we buy one of these entities? And that gets back to this issue of the purchasing decision.

If we're going to allow high leverage, then basically, we're not accepting, the IPP's are not accepting the level of risk that the utility has accepted, and the risk return is not the same.

For instance, at the end of 20 years, the contract expires. If the utility had built that plant, it's depreciated on our books, the customer gets the benefit of those plants, we all have them, we all have undepreciated or fully depreciated plants on our books that are still running, still serving our customers.

The IPP can go out and resell that plant at market prices. You're not buying the same thing because you don't have the risk and reward system in balance.

That's specifically what we're talking about when we're talking about creating a level playing field. And unless we address those things, consumers over the long haul, I think Mr. Smith said those chickens will come home to roost. And they will.

Senator SANFORD. Was it Mr. White or Mr. Elston that wanted to speak?

Mr. S. KINNIE SMITH. Mr. Smith. Excuse me, Senator.

Senator DODD. We have two Mr. Smiths here.

Mr. S. KINNIE SMITH. I'd like to address the issue of excessive debt leverage from the standpoint of a purchasing utility.

The claim that that risk will be passed on to the utility I think is false. It overlooks the essential character of this legislation. That is, that the utility has a voluntary choice whether or not to purchase power from an independent power producer or build a plant itself.

In setting the terms and conditions of that purchase, the utility can literally write the contract and put it out in its bid terms. It can specify the amount of equity that must be required. It can

specify the types of debt, its maturities and interest, the fact that it might have to have fixed interest rates. It can specify any other term that it desires.

That is the way that the power would be bid.

If it is concerned about the effect on its credit rating, it can simply go to Wall Street. It can explain the transaction to its investment bankers, to their rating agencies, to the banks, and if they're told that it's going to affect the credit rating of the purchasing utility, they obviously will not complete the transaction.

This is a voluntary decision by the utility and presumably, they will not make mistakes, and when the State public utility commission reviews the transaction, presumably they will not make mistakes and approve it if the leverage is too high.

You do not have to have heck-or-high-water contract terms. You do not have to have minimum purchase terms. You do not have to have take-or-pay agreements. You can have an agreement which simply says, we will pay for power as delivered or as available.

That is the utility's choice and not the IPP's.

Senator DODD. Mr. Zimmerman?

Mr. ZIMMERMAN. Mr. Chairman, we do have the history of Consumers Power in Michigan. I think you ought to have the perspective of the comments of Mr. Smith because Mr. Smith has currently been able to voluntarily enter into agreements with QS in Michigan. And evidently that's the case because let me tell you, there's been over 2,000 megawatts of QF capacity that's been wanted to be sold into the Michigan market.

As of this time, Consumers Power has contracts on 91 percent of the capacity it's contracted for. They are a participant with an affiliate company in the project.

So, yes, certain power companies would love to voluntarily pick and choose. And that's where the very abuses that we're addressing by PUHCA come into play. They'll choose the one they want to the exclusion of the other.

The question came up earlier from Senator Graham as to whether generation was a natural monopoly and there was dispute here among the industry.

One thing no one is disputing is transmission is a natural monopoly. No question about it.

Senator DODD. How about distribution?

Mr. ZIMMERMAN. I beg your pardon?

Senator DODD. How about distribution?

Mr. ZIMMERMAN. Distribution can be replicated, in my opinion, at competitive prices. It depends on the system and so on.

But I think both distribution and generation can be provided by someone for expansion and cost and still, they would be competitive.

They cannot provide transmission, though. You cannot get the right-of-ways. You cannot duplicate a transmission line that's capable of handling 1,000 megawatts of capacity for a 50-megawatt job. I mean, you just can't do that. The economics aren't there.

The fact of the matter is, though, let's talk, if I may, just a little bit about some of the history in Michigan.

We have figures on just two projects—MCV and the Palisades Generating Co.—which, by the way, according to the record here,

that is an existing, almost highly depreciated plant that has been sold off to a generating company that's been formed, of which Consumers is an affiliate.

In the Palisades Generating Co. case and the MCV case, we have conservative figures that the additional cost due to the private ownership of these, not the traditional utility, will add \$8 billion to the ratepayers' bill.

That's enough to pay the rates of all of Consumers' customers for a 4-year period, to give you an example.

Now this self-dealing and this ability to sign contracts——

Senator RIEGLE. Now Mr. Zimmerman, let me just say——

Mr. ZIMMERMAN. Yes, sir.

Senator RIEGLE. Take a moment, if you would, if I may. It is a Michigan situation. Explain from your view how that works and why that \$8 billion of premium cost comes into the picture. And try to do it in the context of this general debate that's going on here.

Mr. ZIMMERMAN. All right.

Senator RIEGLE. In other words, from your vantage point, what has happened here to cause that extra cost to come into the picture, if that in fact is accurate.

Mr. ZIMMERMAN. All right, Senator. The one hazard, of course, and the No. 1 precept that we're discussing here is the ability to deal with yourself. That is, you have an affiliate that is an IPP or an EWG, whatever the buzzphrase is, and the traditional operating utility company executes a contract with it.

In the case of MCV, which is the Midland cogeneration venture, the price was set for the current assets or some of the assets at the abandoned nuclear plant. Those were sold by Consumers Power Co., which is the operating utility company, at a price of approximately \$1.5 billion.

Now Consumers Power had \$4 billion approximately invested in the project when it was abandoned.

In turn, MCV came in, put in combustion turbines, gas-fired combustion turbines, utilizing the steam turbines that were on this site.

The cost is approximately, on the total project, and this cost was in the contract between MCV, the affiliate, and Consumers Power Co., came in at about \$1,500 a kilowatt. Consultants today have told me that plant could be replicated from scratch without the buying of any existing assets at approximately \$500 to \$600 a kilowatt.

So right off the bat, the price, negotiated, not at arm's-length, in our opinion, but between the two parties, is three times higher than what a private party could truly, or a traditional utility, could build the plant for.

Right there is part of the cost.

To show you how the web gets spun even deeper, Consumers happens to be a gas-operating utility also. The record in Michigan shows that when they went to negotiate a gas contract for their retail sales, they were also authorized to negotiate the gas contract for the MCV, the so-called independent affiliate.

When they did this, strangely enough, the rates that were developed for the MCV project were less than those for the regulated retail sales end of things.

Also, the terms and conditions, although the calculation in recent years has shown the rate in the first couple years of this contract, the rates have come out about the same, it's due to the market, the amount of gas that's being sold currently. But the terms and conditions are significantly different under the two agreements, also.

So all of this interaction has raised not only the cost of the electric customers that are captive to Consumers Power Co., but also now we have a gas company that could be represented as subsidizing the affiliate that's already maximizing their profits.

Senator RIEGLE. Well, let me ask you this, and then I think Mr. Smith ought to have a chance to respond, if he wishes to do so.

And that is, is the point that's at the foundation of the observation you've made the self-dealing point and the fact that if you set up a situation in which self-dealing can occur between these various component parts, if you're taking the retail sales end of it or the transmission end of it or the energy generation end of it, if you allow self-dealing to go on here, you can have abuse. And you think that we've got examples of that. In your mind, this is one.

Is that the principal point you're making, or is there another fundamental point you're making here that would cut through this entire discussion?

Mr. ZIMMERMAN. Well, if the reform goes through, Senator, we do feel that the abuse definitely needs to be addressed.

We feel the only way to address that is to eliminate any self-dealing; that is, the affiliates cannot deal with the operating company, No. 1.

No. 2, we definitely feel there should not be an across-the-board approval or relaxation of PUHCA, but it ought to be taken on a case-by-case basis for this very reason.

There should be review in advance of entering into any contracts and projects or forming of additional companies for this purpose.

Senator RIEGLE. And are you saying that because—didn't I hear you say earlier that you thought that the State agencies might have not the muscle or the staff size, or what have you, to sort of track through all of these kinds of interconnections and so forth?

Mr. ZIMMERMAN. That's correct.

Senator RIEGLE. Is that your argument as to why you need to maintain the Federal authority in this area?

Mr. ZIMMERMAN. It could be done at any level, Senator, at State or Federal. I think it's more appropriate for Federal, going back to the original act, is you've got across to interstate commerce. That is, some of these companies cross borders.

Consumers has international operations with some of its affiliates. So trying to track the flow of money and where the money is being used and appropriated is a major challenge to a regulator who has just a small piece of the pie to look at.

If he's only able to look at the operating utilities books, it's very difficult to tell what is happening.

Senator RIEGLE. Mr. Smith, Mr. Zimmerman has asserted that something on the order of \$8 billion is sort of a premium cost that comes out of this that gets laid on the customer or the ratepayer. What's your response to that?

Mr. S. KINNIE SMITH. We clearly deny that there's any such excess cost at all. [Laughter.]

Let me go back to the beginning. This plant is a cogeneration plant—1,340 megawatts of capacity. One thousand two hundred and forty of that will be purchased by Consumers Power Co.

Without that plant today, we would have a negative reserve margin. Without that plant yesterday, the chief operating officer of Consumers Power Co. told me last night, we would have had a blackout or a brownout in our favorite State, Senator.

This is a key energy source for the Middle West.

Now we could have let the steel rust and the concrete decay at Midland. We elected not to. We created value out of those assets. That value is the core of much of this dispute.

The Michigan Public Service Commission, after extensive hearings, determined what the avoided cost rate was. And that is what is being charged.

Now certain aspects of that are being litigated by all parties, and perhaps will be, and it's in the courts. But it will be decided as a regulated rate under the concepts established by PURPA.

I'd like to address the issue about affiliated IPP's.

If you ban affiliated IPP's, all you are doing is reducing competition. They are well-capitalized, experienced, and expert types of companies. They should be allowed to compete.

The State public utility commissions in Michigan and in other States will review all of the self-dealing allegations, all of the affiliate transactions. The FERC will have the same right of review. Our public service commission has an absolute veto over any contract with an IPP.

The Johnston-Wallop bill strengthens State PUC powers, and we support that.

So we think that the self-dealing issue is adequately handled under existing regulation and the enhanced regulation of the bill.

With respect to the gas contracts, he was kind enough to point out that currently the price paid by the utility under a separate contract because it has a different pattern of needs and loads, is a lower price today, significantly lower than that being paid by the MCV.

Different markets were being served and different prices were being negotiated with the producers. There was no intercompany transfer of value in those gas contracts. That issue was thoroughly argued and debated and decided in the regulatory proceeding.

Senator RIEGLE. May I just ask this? Mr. Lobbia, do you support Mr. Zimmerman's view that the self-dealing issue, either in or out of the Michigan context, is a fundamental issue here?

Mr. LOBBIA. It's absolutely a fundamental issue. I think because of this controversy that we've seen in the State of Michigan, that it's highly likely that our regulators would put severe limits on affiliate transactions or if you want to call it self-dealing.

In fact, there has been legislation that's already been proposed in the Michigan Legislature that would do that. Part of the difficulty

is that then, you put companies like myself in the position where you're not going to be able to build for your own needs because that would be an affiliate transaction or self-dealing.

So now, I can go off and try to build in some other State. And what you do is you take the advantage that a utility has that knows its service territory, that knows the politics there, that knows the customers, and you remove them and you send them off to deal in some other jurisdiction.

Much of what's being said is still premised on the doing it right. Mr. Smith suggests that we can do it by contract. We certainly can. I mean, you can do everything by contract.

All of this should go away. We'll just do it all by contract.

The reality in a State with a regulatory commission, with the oversight they have, is such that it isn't going to be that easy. We see it in our own State all the time. We see a bias away from having the utility do it, to try to find other reasons to get someone else to do it.

We're correcting the ills of the past when we have huge writeoffs in this industry, 98 percent of which were for nuclear powerplants.

You don't have to slap my hand about that. I have the point. I think we understand. I think the market is doing its job there.

This whole concept of doing it right, I would suggest to you that I'll bet Congress, when they enacted PURPA, thought they were doing it right, thought there were a lot of good opportunities, small, independent entrepreneurial, new, renewable energy that they were bringing on. And yet, when we sit here 10 years later and look back, we can see a lot of the problems that have been developed.

I think the best thing I've heard is I don't think you can change this at the Federal level without doing something a different way at the state level.

I don't think State commissions have the horsepower or the staffs, the wherewithal, the experience, to deal with all the kinds of situations that are going to come up as we go forward.

Because what we're doing is we're laying one strip of competition on the business, just on the margin, just creating one little change here.

It's kind of like the old-gas, new-gas in the natural gas industry. We'll just make one little change.

Well, that caused a lot of distortions. I think we have to stand back and answer some of the fundamental questions that Senator Gramm asked about a monopoly, and if not, why subject Mr. Elston and others to SEC?

In fact, why subject the rest of the industry to it? Why don't we spin off the whole generation side of this industry? Let them go out and lever up however they all want to go lever up and let everybody compete for it.

Why just create the special exemption out on the outside?

Senator Dodd. Let me ask, if I can, Commissioner Leonhardt, to respond just to that last point that Mr. Lobbia made about whether or not our State public utilities commissions can in fact deal with this.



I realize that we're talking about one State, but you know the others around the country fairly well, in terms of staffing, in terms of professional ability, and so forth.

How legitimate is that concern?

Mr. LEONHARDT. I think it is a legitimate concern. In fact, I don't think the idea has been put on the table yet, but I think this legislation, if it's ultimately adopted, should have some Federal mechanism to get more resources into the State utility commissions because this is going to be a more complicated world.

Senator Gramm talked about we're kind of going into what you call a gray or a twilight zone, part competition, part monopoly, in these different realms that we've discussed.

As it gets more complicated, more like the telephone industry, frankly, the State utility commissions will frankly have to be more sophisticated than they are today. They were set up to handle the simple integrated companies operating in one State all vertically integrated and so forth, in the old days, the way PUHCA required. And as the whole system gets more complicated, and you certainly see it here this morning, the State utility commissions will need more resources to supervise these contracts.

I'll just pick up on a couple other points, if I may, too, for a second.

Senator Riegle was concerned about this situation in Michigan. I'm not an expert. I've read a little bit about the tough plant you had out there and everything. I'm not expert in it. But I would say that plants that have come in in the traditional system of rate-based regulation and the old way and so forth, they have not always had, and particularly in the last 10 years of the nuclear industry in this country, an easy history.

You can come in the old way and it's going to be tough, too.

So you come in the new way, and there's going to be some difficulties and everybody starts saying, self-dealing and raising that flag and everything and that gets people aroused and so forth.

A lot of the plants that came in in the old way were not without their problems.

PURPA's had a bad time here this morning. And sure, there were some problems. There were some excesses. Everybody said, this small generation and cogeneration and alternative energy sources, this is going to be great in the 1970's and everything. And maybe we went a little far. But actually, more nonutility generation was built in this country last year than utility generation.

Really, PURPA, on the whole, Jim Crowe is right about some of the excesses. We're going to address them in Connecticut in terms of avoided costs being too expansively interpreted and PURPA being given such a special status, more than it deserved and unfair to the traditional utilities.

That's right, and we will address it at the State level, which is where FERC delegated the definition of avoided cost.

But, really, PURPA's done a lot of good. It shouldn't be lost along the way here. It's built a lot of power. It's brought a first step in competition and generation in this country.

Yes, there are problems. There are with anything new and they're being addressed now and corrected. And I don't think PURPA should be seen as a nightmare.

Excuse me for wandering around.

Senator DODD. Jim.

Mr. CROWE. Chairman Dodd, I'd just like to comment further on this, particularly in regard to the State commissions and their ability to deal with these issues.

I think it doesn't necessarily go to just the resources of the commission or the competency level, the experience level of the commissions. But if you look, for instance, in New England, the temptation is very large for any given State. There is competition among the States, not only the utilities, but among the States themselves. And the temptation is very great.

Connecticut, for example, has had a concerted, long-range plan to reduce our dependence on oil. My company was 94 percent dependent on oil in 1971. Next year, we'll be 12 percent dependent on oil.

It cost a lot of money to do that and our consumers are paying for it, but we think they got something.

On the other hand, the expansion that's going on in other States, two of which touch our borders, and others in New England, don't have those same elements of planning. I think the temptations is there at the State level to take advantage of the short-term expansion of the relatively inexpensive and right now plentiful gas supply with these kinds of IPP projects that are gas-based, relatively inexpensive, highly leveraged. And if everything goes OK, then the consumers get the advantage of that.

But they don't have the same where's the beef? They don't have the same meat behind them that the utility infrastructure has.

I think the temptation is there among other States and their commissions and they have the ability to tamper with the RFP's, the requests for proposals that are going out, the setting of the scoring system.

Theoretically, we can say, yes, you can do these things by contract. Massachusetts Utility didn't want to exclude utility bids. They can't do that by contract. They can't require certain debt/equity ratios in these bids because these scoring systems are being developed by the States. At least the ones that we bid into.

We bid into an RFP in New York State and we lost. We were told that it was on price. They couldn't have possibly beaten our price with a new plant.

Somehow, in that scoring system, the new plant, the IPP or whatever was purchased down there, got some kind of a preference in the scoring system, which I believe, through the interaction of the utility and the State, was constructed to favor the IPP's.

I think we need some Federal guidelines to control this kind of tampering that keeps the important planning parameters in our power supply. And with that, and it's going to be difficult to do, with that, I think we can then go ahead and talk about more competition.

Senator RIEGLE. Mr. Chairman, if I can just make a couple of observations sort of in general having to do with a number of the comments that have been made here today.

If you step way back from this, if we had the general public in the room here today, and there isn't much of the general public in the room today, which is a matter of concern to me.

I think to the extent that they are, they're here around this table, as properly they should be, and that's our job.

But I think the issue of the impact on what's happening to people in their lives today, just the economic realities in the country, are really quite severe. Even if somebody is in an elevated financial position and is sort of removed from all of the economic riptides that are going through the economy, boy, you'd have to be really tuned out not to understand that an awful lot of people are hurting in the country.

And the aggregate data on that shows that over the last 20 years, median family income for sort of middle income people in this country has stayed just about the same. There's been no real improvement that one can measure in disposable family income after inflation over the last 20 years. People are working a lot harder. Two people are working in one family to sort of try to keep up, but it's a treadmill operation for most of the people in the country.

The data is inescapable on that point. I won't go into it in great length here now.

One of the unavoidable costs that virtually everybody in the society has to cope with, unless they're living out under a bridge in a cardboard box in a doorway, is the cost of public utilities, along with the other absolutely basic requirements in life such as food and shelter.

But the public utility cost is there for just about everybody in our society. It is, in my view, a fundamental cost of living.

There is a very powerful public interest argument I would draw from that that says, first of all, you want to make sure you've got enough of it in the way of the power requirements that the country needs, but you also want to make sure that you're getting it out there in a way that keeps those costs down.

And if those costs are measurably higher than they otherwise need to be, we really miss the boat as a society.

Now, I think it was unfortunate that we sort of veered off earlier in that conversation about whether we're really talking about some sort of communism or some kind of a central planning mechanism coming in here and really sort of wrecking the values of a more freely operated market economy.

But it's worth noting that the reason that we're having this hearing today is we couldn't have it any sooner because we've been having nonstop hearings in here on all of the wreckage that's accumulated from the blowoff of the 1980's.

We've got a bill right now to borrow \$70 billion to refinance the Bank Insurance Fund because it's empty. The latest estimates on the savings and loan debacle are about \$700 billion. It may hit a trillion before it's done. That's a 30-year cost.

We've got other major problems out there which I believe are not yet fully recognized in other financial areas.

It's hard to draw these historic parallels, but I heard the talk about we don't want to just go with what we did in the 1930's, the sort of anti-Depression measures and so forth and so on.

What we did in the 1930's was the result of what we did in the 1920's. I don't want to lose sight of some larger timeframe because

I don't want to go back to the 1920's any more than we already have because I don't want to go back to the 1930's.

We may be on the verge of that because we've had kind of a 1920's mentality, a roaring 1920's mentality in terms of the roaring 1980's mentality.

I'll tell you what I'm concerned about as I listen, and I appreciate the points of view that everybody's been expressing here.

I'm a little nervous about the leveraging opportunities. I look around the room and there's an awful lot of moneyed interests represented in the room quite apart from those of you around the witness table. I mean, there are billions and billions and billions of dollars at stake here, depending upon how these decisions go. They may look nice and neat and trim, but there are huge financial stakes here. And out on the other end of it sit all these consumers in our country who are very far removed from this process who don't have any extra income to give you or anybody else that they don't otherwise absolutely have to because they need their money for basic things.

So if the cost of electric power or other power generation is driven up by an extra penny or nickel or dime or dollar or multiple of dollars, I think it hurts the country and it sure hurts those people. And that's got to be the bottom line test here.

The bottom line test is what gives us an efficient system that keeps those costs down, keeps a reliable system in place with enough energy, but keeps those costs absolutely at a rockbottom minimum. At a rockbottom minimum.

We need that because the country has got some very tough problems to solve economically. We talk about the Soviet Union. They've got tough problems to solve. But we've got very tough economic problems to solve in this country also.

So we can't afford a misstep here. And we can't afford to veer off track and find later on down the line, that we're eating premium costs that we could have avoided because, by and large, the people that make the decisions won't be eating the costs. They'll be passing those on to somebody else. And the people that are going to be asked to eat them can't afford them.

I don't want to see that happen.

So the bottom line here I believe is that as we go about trying to make sure that we've got sufficient competition in the system, and I want to encourage as much entrepreneurship as we can manage—that is a part of what drives this country. But when it gets out to the other end, when somebody's plugging a toaster into an electrical outlet or turning on a television set or turning on their furnace in the wintertime, I want people to be assured that they're paying the most efficient and the lowest price that they can pay to have that power available to them.

I think it's the obligation of everybody around this table to see that that happens. That to me comes way ahead of maximizing value for shareholders, maximizing executive salaries, and maximizing the size of organizations.

Those are all quite proper things within a narrower scope of interest in our system. But the bottom line in the end in terms of providing the power needs of this country is how do we get a sufficient amount out there at the lowest price to consumers?

And if we get off the mark in terms of that objective, we're going to end up hurting this country. It might help a firm. It might help an executive of a firm. It might help a shareholder of a firm. But it will hurt America. And if it hurts America, then it's bad policy.

And I don't want to see it happen if that's the situation that we're going to find ourselves facing.

Thank you, Mr. Chairman.

Senator DODD. Thank you, Mr. Chairman.

I just would add, and I certainly don't disagree at all with what my chairman has said. But one issue that we really haven't spent as much time on here this morning is the supply question in terms of long-term energy needs. And obviously, price is extremely important. In fact, fundamental.

Obviously, what's also important is to try and look down the road and see what our supply needs are going to be, where those supplies are going to come from.

And I commend what Jim has done in Connecticut because we've moved away from this dependency, this lunacy, in my view, where we're today far more greatly dependent upon the most precarious region of the world, in my view, for these supplies. And the more rapidly we can move away from that and begin to appreciate what the demands will be for a society that will have to be tremendously competitive in a global economy, also, it seems to me, is a crucial element.

And while it's certainly been touched upon here this morning, we spent a great deal of time talking about competitive elements in the bureaucratic structure and so forth. But I'd like to hear some discussion about the prospects of supply. Those I know argue that are opposed to this is that there is plenty of supply out there already, that there's really not a tremendous need to move forward here.

I accept that today. However, in my State there's been a debate—those from Connecticut will appreciate it because it got into a heated debate in the little town of Norwich, CT, over a thing called Uncuses Leap, which is a sensitive, historical and environmental piece of property in the town my greatgrandparents settled in when they came to this country. Recently a small generating power property was built on the property.

One of the arguments is we don't need it, that there's already excess capacity.

But, nonetheless, I suspect going down the road, as you look ahead, by the end of this decade, the early part of the 21st century, there's going to be obviously a need for additional supply.

I would hope that we're looking at ways in which we're less and less dependent upon outside resources, although that doesn't seem to be the case, at least in the near short-term past, as we now consider where we are on that particular score.

So I'd be interested in hearing that.

I'd also like you to get a bit specific, if you could. We've been rather generic here this morning. I'd like to know from those who support this legislation specifically—why the changes in PUHCA, what specific changes in PUHCA are really going to be beneficial. And I suppose from those who are in opposition, why those specific

changes in your view are going to create the kind of problems that you've discussed here.

But I need to know in some sense, to rate these changes that are occurring in the legislation in terms of their gravity, I guess, might be helpful.

So if you'd care to comment on Senator Riegle's comments as well, we'd be willing to entertain that.

Mr. S. KINNIE SMITH. Excuse me, Mr. Chairman. I'd like to comment on the need for power in this Nation.

The Department of Energy has made an estimate that by the end of this decade, we will need between 100 and 150 gigawatts of additional capacity. That is 100 to 150 major, large plants would have to be brought on line.

The indications are now in the plans of the integrated utilities that, at best, 50 percent of that will be provided by the standard utility industry.

That is the reason why——

Senator DODD. Whose estimates are those?

Mr. S. KINNIE SMITH. Those estimates, I believe, are in the DOE report and a number of independent analysts have come up with approximately the same numbers, and we'll provide that for the record.

There are a number of studies that are all within this range. In fact, a recent one was issued by the Energy Information Agency, I believe it's called.

We'll provide that.

Senator DODD. I appreciate that.

Mr. S. KINNIE SMITH. Therefore, it is essential that this legislation be passed so that we can have a vibrant, independent power industry.

If you are limited to one plant in one State, you're not going to dedicate the people and the capital to this industry. When you can do it on a multistate basis, then you will find the strong companies that have the engineering talent and the financial capabilities entering this industry and competing.

That will be largely in terms of competing in a competitive bid environment. Over 26 States now either have competitive bidding or have proceedings leading to competitive bidding to assure that this new capacity comes on at a lower cost.

With respect to changes in the pending bill, we are in substantial agreement with the Johnston-Wallop bill. We've also looked at the PUHCA portions of the bills on the House side and find that they all contain very soundly conceived protections for the consumer interest, the ones that I had mentioned earlier.

We have no disagreement with providing all the protection that's needed to prevent self-dealing.

We do strongly urge that if this power need is going to be met, though, that affiliated IPP's must be allowed to compete because they are some of the strongest companies in terms of their engineering and operating capabilities.

I tried to address your question. Thank you.

Mr. PATRIZIA. Mr. Chairman, one of the privileges that I had before I took on the role that I have now was to have worked in the U.S. State Department. And part of my duties during that

period were to be at the International Energy Agency in Paris, where I was responsible for studying the security of the energy supplies to the entire OECD.

So I am very sensitive to the question that you raised about the security of our energy supplies and where those resources are going to come from.

I think three things have to be said about that.

The first one is that, as has already been expressed by the gentleman from Connecticut and from your own recognition, Senator, that there has been great progress in this country in moving away from oil as an input to our electric generation sector. We still have an incredible amount of dependency on oil, but it's mostly in the transportation sector. It's no longer in the generation sector.

That has to continue, however. We need to be sure that the fuel mix as we move into the future continues to be a reliable mix of fuels, including all the kinds of generation that we can have and including conservation and demand-side management.

All of those programs have to serve a role and that's the second point.

The third point I would make is the one that the gentleman from Connecticut has already made, and that is that there has to be a planning process that the utilities have control in to make sure that process works. We cannot have a situation where the planning process is left to the vagaries of politics. We cannot have a situation where the planning process is left to short-term views or short-term economics.

When we did that, we ended up very dependent upon oil supplies and it was a major problem for us when we had oil supply disruptions in the 1970's.

For those of us who went through the policy process at that point, it's something we don't want to repeat.

Senator DODD. Let me go to this side of the room.

Mr. PATRIZIA. Mr. Chairman.

Senator DODD. Yes.

Mr. PATRIZIA. Can I address the other couple of questions that you had?

Senator DODD. Yes.

Mr. PATRIZIA. It seems to me that the question is not whether additional generation capacity will be needed, but when. And that situation is going to occur differently in different parts of the country.

While we have a very vibrant economy nationally overall, it seems to be back on the growth path, it's a big economy and it varies very much region to region.

I think that rather than trying to decide how much capacity we're going to need nationally, it's a question of what kind of capacity we're going to need where and when.

I also don't think the question is if that capacity is going to be built, but how. There is going to be some independent power capacity. There is going to be some utility capacity. There's going to be conservation. There's going to be demand-side management.

All of those have a role to play and should play a role as we move out beyond 2000.

Senator DODD. Let's come back on this side of the room. Jim, do you want to respond?

Mr. CROWE. Let me just make a quick list and I'm sure others can add to it.

Specifically, we'd like to see the elimination of the privilege status under PURPA. I think this is an important message if we're going to go forward and stimulate more competition. We should go back, give an important message that we're going to eliminate the privileges under PURPA, and things are in fact going to be, decisions are going to be made on a truly competitive basis.

We're going to require in some fashion that when there is competition, that everybody's competing on equal terms in regard to leverage and tax status, that we're going to deal effectively with the transmission access issues to be sure that everybody has a fair shot at the market, that we should set purchasing guidelines for commissions to assure that we have the important planning parameters built into our system, that we don't have the temptation or that we eliminate the temptation for the short-term gain of people not holding up their responsibilities in terms of long-term reliability and security of supply.

I didn't make the point earlier, but we have this tightly integrated pool. If somebody fails in one of the other States, they can lean on the other States and that's just not right.

We have to have the proper incentives to go and build a sound utility infrastructure and go forward.

Senator DODD. Would you respond, Jim, as well to the criticisms raised by those of you who oppose the legislation, generally oppose, that, in fact, in responding to Mr. Patrizia's point, that we're going to need additional generating capacity.

Mr. CROWE. Absolutely.

Senator DODD. And that by restraining the access to competition or to entry by the independent power producers, that, in a sense, we are limiting in a way our capacity to create that additional sources.

Mr. CROWE. I'm not sure I would characterize it that way.

I think the introduction of sound competition into this marketplace under the kinds of guidelines that I listed is good for the industry. Competition will make us all do a better job.

I think the central issue for this country in regard to the future supply is where is the energy going to come from? And I think it's primarily an environmental issue.

The technology, the resources, the capability are there. They're there on the IPP side. They're there on the utility side.

I think it really comes down to an environmental issue.

Mr. HEMPLING. If I may address the environment issue, Mr. Chairman.

Senator DODD. That's appropriate, Mr. Hempling.

Mr. HEMPLING. The point that is not coming through clearly is the interaction between title 15's changes to the Holding Company Act, which doesn't say anything about the environment, and this desire to build more capacity.

And I want to make that interconnection as clear as I can for you.



You don't see proponents of title 15 from the solar industry, the wind industry, the biomass industry or the conservation industry. You see the proponents of title 15 from the construction industry.

I'm not against construction. I'm not against efficient competition. But one must ask the question, why are the proponents of title 15 all from the construction side of the industry?

Now if I can do this as clearly as I can, remember what the changes to the Holding Company Act in title 15 will do. They will permit entry into the industry without any review by the SEC and without any review by the FERC.

That's point No 1.

Point No. 2, what happens when an existing——

Senator DODD. Let me stop you at this point.

Mr. HEMPLING. Yes, sir.

Senator DODD. I understood FERC was still very much involved here.

Mr. HEMPLING. Not in terms of entry, sir. Just in terms of rate-making, and I will come to that in a moment.

So the first step is entering the industry. Under the Holding Company Act today, there is review, as several people have mentioned. After title 15 is enacted, there will be no review. Someone simply enters. That's step No. 1.

Step No. 2, what happens when the entrant is a wholesale generator, which is the type of entity that title 15 would create? A wholesale generator sells at wholesale to a retail utility.

Remember that wholesale transactions are FERC jurisdictional transactions, not State jurisdictional transactions.

Why is that important? It is important because there is now a doctrine called the preemption doctrine which came with the case called Mississippi Power Light that many people have testified to. And with certain kinds of wholesale transactions, once FERC approves the wholesale transaction, the State commission that Mr. Leonhardt, his counterparts in Michigan and elsewhere, lack any jurisdiction to protect ratepayers from that passthrough.

Now why does that matter?

It wouldn't matter at all if FERC ratesetting was a highly competitive process where all alternatives—conservation, biomass, nuclear power, fuel, et cetera—were placed in one room and forced to compete with each other, everyone having fair access to the transmission highways.

But that is not the FERC ratemaking process. The FERC rate-making process today is distorted, not all at FERC's fault because FERC lacks the authority to order fair access to the transmission highways.

The point is that FERC, although lacking the authority to ensure fair competition, can also make things worse by awarding what we call market-based prices where there is not actually a competitive market.

To summarize, if title 15 permits the creation of wholesale generators, if the creation of wholesale generators preempts State rate-making, if FERC ratemaking is biased in favor of construction and not in favor of a level playing field among all sources of load, management and production, that is the connection between title 15 and construction.

So the issue is not whether we need more powerplants. The issue is whether there will be a methodology for comparing the alternatives, a methodology which is regulated and planned by those who know the alternatives the best, and that's the State commissions.

And what title 15 does is create a huge State jurisdictional gap in the absence of an ability by FERC to ensure a fair market.

So that's why I am for title 15 doing it right, as Chairperson Leonhardt said. But doing it right will take a great deal of discussion, sir.

Mr. ELSTON. Mr. Chairman, if I could address the environmental issue as well, or do you want to come back to that?

Senator DODD. Well, let me finish up on this point, and then we'll come back and make the last point the environmental question.

But on this particular point here, do we have—

Mr. SHERWOOD SMITH. On the supply matter?

Senator DODD. Yes.

Mr. SHERWOOD SMITH. May I speak to that?

The definitive document in existence dealing with whether or not there is an adequate supply of electricity in this country, and is likely to be, is the annual report of the North American Electric Reliability Council. It covers this country and it covers Canada and it covers the nine interrelated regions.

Senator DODD. Is this the same crowd that ran that ad in the Hartford Courant?

Mr. SHERWOOD SMITH. No, it's a different organization. [Laughter.]

Senator DODD. Boy, that would have been about the dumbest thing you could have said here today. [Laughter.]

Mr. SHERWOOD SMITH. But they, too, are concerned about the availability of service and the cost of service, Senator Dodd.

But the North American Electric Reliability Council, or NERC, has consistently said that the electric utilities do have adequate plans for the future for providing electric generation.

It will be provided in many of the ways that Mr. Patrizia stated. It will be provided through conservation and load management where that's effective, through purchases from nonutilities under existing law, where that's economical and effective, and utility generation construction.

There is no crisis. In fact, the most recent report of the North American Electric Reliability Council—

Senator DODD. I don't think, Mr. Smith, anyone said, at least I didn't hear that debate, that there's a crisis today. The question was whether or not and to what extent additional generating capacity was going to be necessary in the immediate future.

Mr. SHERWOOD SMITH. It will be necessary and the utilities are prepared to build that and to meet that demand.

In fact, the most recent report shows that reserves in New England are predicted to be higher at the end of this century than previously forecast.

So there's no supply crisis that means that we should let everybody come in and be unrelated and build generation plants.

Senator DODD. That's not Mr. Patrizia's point because—we're going to end up losing some population in the Northeast and you're gaining population elsewhere.

So I guess you've got to be careful about what part of the country you're talking about.

Mr. PATRIZIA. It is a regional issue, Mr. Chairman. But as Mr. Smith points out, the North American Reliability Council is an organization created under congressional auspices following the famous Northeast blackout, in order to be sure that there was in fact reliability concerns being addressed throughout the country.

And that council is made up of a variety of regional organizations that worry about the reliability within particular regions of the country.

It is distinct from——

Senator DODD. I heard Electrical Reliability.

Mr. PATRIZIA. I understand, Mr. Chairman. That's a distinct organization and I won't say who in this room comes from that group.

But the point is that regional supply does have to be looked at regionally. There are of course integrations in the grid. But it has to be looked at on a regional basis, depending on the needs there.

Mr. CURRY. Mr. Chairman.

Senator DODD. Yes.

Mr. CURRY. The other part of your question, in addition to the need for electrical power in the future had to do with what specifically we required or what specifically we felt would take bill 1220 and make it achieve the things that we hope for it to achieve.

I think that can be done. We've submitted an amendment that we feel is very narrow and very targeted on two specific issues. The FERC needs to be able to order utilities to provide nondiscriminatory access, keeping all the other protections that they have, including ensuring reliability and fair compensation.

That's one thing.

The other thing is that we propose very simple and targeted issue. We've already talked a lot in here about the difficulty and the additional resources needed to regulate and handle self-dealing.

Very simply put—no PUHCA-exempt self-dealing.

Those two things, very simple and very targeted, can make this bill accomplish what we feel needs to be accomplished in order to provide the consumer with lower rates.

Senator DODD. Cliff, you mentioned some things that you thought support the amendments with some changes. From a public utility commissioner's standpoint, what are some of those changes?

Mr. LEONHARDT. Right.

Senator DODD. Would you be speaking for yourself here or are you speaking for the national organization?

Mr. LEONHARDT. For myself. But my comments will correlate closely with NARC, the National Association of Regulatory Commissioners. So we're not here on their behalf today, but close to their views.

I agree with Scott Hempling. The prudence review over purchase power does not go far enough in the bill. And this could be of specific relevance to us in Connecticut.

If NU and PS&H merge, in section 15106 (D)(2) and (D)(3)(b) of the bill, there would be a major loophole where, under the current language, if PS&H purchased power from an EWG affiliate and then subsequently sold or interchanged this power to CL&P, the Connecticut DPUC would be expressly preempted from reviewing the prudence of CL&P's purchase.

So that would be like one right at home-type issue for us.

More generally, the compromise that came out of the Energy Committee in the U.S. Senate kind of at I think sort of the last minute, came up with this new idea or new to this context of the prior approval provision. I would argue that the State commissions have to be able to review the prudence of the contract execution on an ongoing basis.

In other words, the bill in its current form has a prior approval where the utility can request prior approval of an EWG purchase. I think that's an attempt to get past the problems of the nuclear construction program in the last decade and all the headaches that caused everybody. And the utilities have many valid points.

But I think the State commissions are going to have to stay involved in looking at the prudence of this on an ongoing basis.

After that, I think we need to be able to look at the EWG's affiliates and parents' companies' books and records, as well as just the EWG itself, which is now in the bill, take this ability to look into the records further than the bill itself takes it at the current time. And then the area you, Senator Dodd, hit on earlier, I think very important.

It's great to have all of these legal rights and everything at the State level. We hope the Congress will give them to us and underscore them. But without some kind of funding mechanism to have a staff to do these things—and the truth of the matter is, today, a lot of your inhouse staff has somewhat limited capacity to do this. You're honestly talking about bringing in—we have a very good management audit statute that the Connecticut Legislature passed for us where we can assess the utilities and go in and look at this cost of service stuff in a lot of detail.

We'd bring in a Booz-Allen or some other big firm to do it, what we couldn't do ourselves in New Britain.

I think that if we're going to go this route, as we should, at the Federal level, as you brought out in your earlier question, we're going to have to give the States some real funding mechanism under Federal law, I believe, assess the utilities, whatever, not taxpayer dollars, to really implement these legal rights.

Senator DODD. Well, Mr. Chairman, this has been helpful. The hour we've reached—it's noon. We could literally go on all day here. I want to make a couple of comments just briefly, if I can.

First of all, I've learned a great deal from this process here this morning. It's been very worthwhile to have the interchange here at the table between the various points of view that are represented obviously here.

I want to thank Cliff Leonhardt as well. He gave me a very good document that sort of laid out the points on all sides of this issue a week or two ago and gave me a chance to acquire a superficial knowledge of this issue. From my standpoint, it's a very complicated area.

But it's been tremendously helpful as we look at this, and the record I think will be valuable to our colleagues as well, Mr. Chairman, in at least understanding the debate and the points that have been raised here this morning.

I want to underscore what the chairman said about costs. We have a tendency to—and I was very impressed this morning that virtually every single one of you, in discussing this issue, made it rather clear that you had in mind cost and that competition wasn't an end in itself, but what it would produce and how important that is because too often in these debates, we forget that the crowd that Senator Riegle talked about is really what we're addressing here; in a broader sense, the country.

But specifically, in these instances, the tremendous economic pressures and hardships they feel, and this being such a vital element in their well-being and our economic strength, that the public policy decisions that we make here have a profound effect on those decisions.

And your input and your involvement at least help us sort out those questions.

I don't know what the likelihood is of the Johnston-Wallop bill moving. I think most of you probably follow the politics of this more closely than I have over the last several days. But I gather that it's stalled. And whether or not we're even going to get legislation this year is highly questionable.

But, nonetheless, these issues are not going to go away. That's for darn sure. We're going to have to deal with them.

So I want to thank you on behalf of the subcommittee and the full committee for your patience, your time, your involvement. We'd like to make this an ongoing relationship here, in that as we move forward and as we come closer, any additional comments and thoughts you have in this regard, title 15 of the legislation, would be extremely helpful I think to all of us.

So, Mr. Chairman, unless you have some closing comments—

Senator RIEGLE. No. Chairman Dodd, I sort of made my closing comment earlier, I think.

I just want to commend you and the staff. I think this has been a very good format. I think it's helped bring more relevant material to the surface, along with all of the prepared statements which are being part of the record.

I look forward to working with you to pursue this issue beyond today.

Senator DODD. We thank you all very much. If there are any additional questions by the members of the committee, we'll submit them to you.

But I thank you for your patience here this morning. The subcommittee stands adjourned.

[Whereupon, at 12:06 p.m., the subcommittee was adjourned.]

[Response to written questions, prepared statement of witnesses and additional material supplied for the record follows:]

**SUMMARY**  
**STATEMENT OF S. KINNIE SMITH, JR.**  
**CMS ENERGY CORPORATION/CONSUMERS POWER COMPANY**  
**BEFORE THE**  
**SUBCOMMITTEE ON SECURITIES**  
**OF THE**  
**SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS**

The United States will need 100,000 to 150,000 additional megawatts of electricity - the equivalent of 100 to 150 large generating plants - to meet growing energy demand in the 1990s. Without these plants, the country is headed for substantial electricity shortages. But utilities are building less than one-half of the electric generating capacity that is needed. Instead, many utilities prefer to meet their future power needs through purchases from independent power producers (IPPs).

IPPs are entities engaged exclusively in the business of generating and marketing wholesale power to utilities and have become an increasingly important energy supply option for utilities. But future development of IPPs is limited by the Public Utility Holding Company Act of 1935 (PUHCA).

PUHCA was enacted to breakup huge, diverse multi-state utility holding companies. Using its authority under PUHCA, the SEC successfully restructured the electric utility industry. Of the more than 2,400 companies which at one time or another were registered under the Act, only 12 active registered holding company systems remain. State public utility commissions have extended their regulatory effectiveness over the operations and finances of electric utilities and over transactions with their affiliates. FERC has vigorously regulated wholesale power transactions, and the SEC's requirement for full disclosure of all financial and operating data by publicly owned utilities and holding companies under securities laws has protected utility investors from the abuses which led to PUHCA. With the problems of the past corrected, it is appropriate to look at the effects of PUHCA on the present condition of the electric power industry and its future.

Currently, under PUHCA, ownership of 10% or more of the voting securities of an "electric utility" will subject any company, whether utility or non-utility, to the extensive regulatory requirements of PUHCA. For IPPs, the practical effect of PUHCA is to limit operation and ownership to a single generating plant in a single state. In the case of a utility or an exempt holding company, PUHCA effectively prevents them from investing in generating sources in states outside their traditional service territory. If an IPP, utility or exempt holding company violated these ownership limitations, they would be required to become a registered holding company and thereby subject to complex and detailed regulation of the financial and other everyday aspects of their business. Few, if any, major investors in IPPs would elect to subject themselves to this extensive regulation. The only remaining option is to invest in IPPs which have highly complex and distorted capital structures that prevent the investing company from exercising voting power or managerial control.

Title XV of the Johnston-Wallop bill (S. 1220) would effect a very narrow change to PUHCA by exempting IPPs from the ownership limitations of PUHCA if they generate power for bulk sales to utilities. The impact of this narrow change would be to allow utility and non-utility entities to make substantial investments in IPPs in any state - wherever the need for power occurs.

More importantly, utilities would have significant new supply options. The choice of whether to purchase from an IPP or construct new generation capacity themselves, if it would provide a lower cost or more reliable source of generation, is completely voluntary. With this freedom of choice, PUHCA reform will result in lower future generating costs for utilities and their customers. A recent DOE cost-benefit analysis estimated that the present value of benefits to consumers over the 1991-2000 period varies between \$871 million and \$5.2 billion.

PUHCA reform is not deregulation. State and federal rate regulation and securities laws remain in full effect as will the regulation of holding companies under PUHCA. In addition, S. 1220 contains a series of provisions that reinforce and expand the powers of state public utility commissions to protect consumers. The extended state PUC powers include (1) prudence review to assure that the least cost option is selected, (2) review of transactions with affiliates to prevent cross-subsidies and other abuses, (3) access to books and records and (4) review of the effects on reliability and rates of the IPPs financial structure. Allegations by utility opponents of PUHCA reform that IPPs will undermine reliability of electric service, force utilities to purchase unneeded capacity, and eliminate the obligation to serve are misleading and false, and reflect the mindset of monopolists who fear and oppose competition.

Some have suggested severe or even total ownership restrictions on utility affiliates qualifying as IPPs in the utility's service area. Such a restriction would be both unfair and harmful to electric customers. By barring a utility affiliate from the competition, the consumers may be seriously harmed by eliminating one of the most experienced and potentially lowest cost competitors. It should be noted again that federal and state regulators have sufficient existing authority to ensure that no affiliate-related self-dealing abuses and cross-subsidies occur.

A final issue relates to transmission access. Some suggest that you cannot have competitive wholesale generation without broad, mandatory transmission access legislation. I agree that transmission access is necessary, but believe that it will be provided voluntarily. A combination of voluntary access granted by utilities desiring to purchase power in a competitive market and FERC's condition of open access before approving market-based rates for IPPs have created an open grid enabling "free entry" into the wholesale generation market for all IPPs. If Congress



decides to address transmission access in connection with PUHCA reform, however, it is vital that such legislation contain appropriate protections for the economic interest of native load customers and the reliability of service to all customers, as well as allow growth of an independent power industry.

**UNITED STATES SENATE**  
**COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS**  
**SUBCOMMITTEE ON SECURITIES**

**SEPTEMBER 17, 1991**

**TESTIMONY OF S. KINNIE SMITH, JR.**  
**PRESIDENT, CMS ENERGY CORPORATION**

Mr. Chairman and Members of the Committee.

I am S. Kinnie Smith, Jr., President of CMS Energy Corporation, the parent of Consumers Power Company, the Nation's fourth largest combination electric and gas utility. Consumers Power serves six million of the nine million residents of Michigan. CMS Energy is an exempt holding company under the Public Utility Holding Company Act of 1935 (PUHCA).

I am pleased to appear before this Committee today to discuss the issue of amending the Public Utility Holding Company Act of 1935. Our company is a strong supporter of PUHCA reform and we are members of the Utility Working Group, a coalition of electric utilities that supports PUHCA reform.

My testimony today reflects the dual interest we have in enactment of PUHCA reform legislation. As a utility, Consumers Power supports reform as a means of creating new, competitively priced power supply options to meet the growing energy needs of its industrial, commercial and residential customers. As an exempt holding company, CMS Energy is interested in applying its experience and expertise to the construction and development of independent

power plants in areas of the U.S. and abroad where energy shortages are particularly acute.

#### The Need For PUECA Reform

America's electric utilities need energy supply alternatives in the 1990s.

The U.S. Department of Energy, as well as independent analysts, conclude that to meet growing demand, America's electric utilities will need 100,000 to 150,000 additional megawatts of electricity in the 1990s - the equivalent of 100 to 150 large generating plants. Without them, the country is headed for electricity shortages, despite substantial investment in conservation initiatives. But all of this new capacity will not be built by the nation's traditional electric suppliers, the utilities.

In fact, utilities are committing to less than one-half of the new electric generating capacity that will be needed nationwide between now and the end of the decade. Instead of building plants themselves and subjecting themselves to the risk that they will not be allowed by regulators to recover their investment, many utilities prefer to meet their future power needs through purchases from independent power producers (IPPs).

### The Role of IPPs

IPPs differ from traditional utilities in a number of ways. IPPs are exclusively in the business of generating and marketing wholesale power to utilities who in turn are responsible for the transmission and retail distribution of that power. Unlike utilities, IPPs do not have franchised service areas or guaranteed markets to sell their power. And, whereas utilities rates are set by regulators on a cost-of-service/rate-of-return basis, IPP rates are established by contracts between the seller and the purchaser and often pursuant to a competitive bidding process involving other wholesale power suppliers.

As the Congress, state and federal regulators, and state legislators adopt policies promoting competition in the generation of electricity, IPPs have become an increasingly important energy supply option for utilities. Indeed, over 50 percent of the new generating capacity constructed in the past two years was constructed by IPPs, primarily plants meeting the requirements for "qualifying facilities" (QFs) under the Public Utility Regulatory Policies Act of 1978 (PURPA). Consumers Power, in recent years, has relied heavily on power purchases to meet rising energy demand. In 1990, for example, 37 percent of

Consumers Power's electric sendout was purchased from IPPs and other utilities. Over 15% of its available generating capacity is provided by the Midland Cogeneration Venture 1340 megawatt cogeneration plant constructed by converting an abandoned nuclear plant owned by Consumers Power in Midland, Michigan. It also purchases power from a number of smaller IPPs.

It is generally agreed, however, that future development of independent power projects under existing law is limited. Not all IPPs can meet PURPA's requirements for QF status -- and thus be exempted from PUHCA -- and alternative corporate structures are heavily constrained by PUHCA. Experienced and financially strong energy companies like CMS Energy are ready and willing to invest in wholesale power generation, but are restrained by PUHCA's ownership limitations.

The Holding Company Act successfully restructured the industry decades ago, but now prevents the growth of a vital and competitive electric generation market independent of the fully integrated, franchised electric power industry. With the abuses of the 1920's corrected, PUHCA should be reformed to look forward to help meet the increasing electric power needs of the nation. At the same time, it

should provide protection and benefits to consumers in the new competitive climate of the 1990's and the next century.

#### The Problem Created by PUHCA

PUHCA was enacted over 50 years ago to break up huge, diverse holding companies, a handful of which controlled over two-thirds of the country's electric generating capacity. The complex corporate structures of these holding companies and the absence of effective state or federal regulation led to self dealing, cross subsidization and other abuses to the detriment of both consumers and investors. Using its authority under PUHCA, the Securities and Exchange Commission completely restructured the electric utility industry.

Today, about one-half of investor-owned utilities are not affiliated with a holding company system. Of the more than 2,400 companies which were at one time or another registered under the Act, only 12 active registered holding company systems -- nine electric and three gas -- remain. There are approximately 90 utilities that are exempt holding companies because they are either predominately intrastate or predominately operating utilities. But, the Act that decades ago successfully restructured the industry now

prevents the growth of a vital and competitive electric generation market.

Since enactment of PUHCA in 1935, state public utility commissions have extended their regulatory effectiveness over the operations and finances of electric utilities and over transactions with their affiliates. Detailed utility accounting principles have been applied by state and federal utility regulators to assure that costs and revenues of utilities and their parents and affiliates can be tracked and properly accounted for in rate, securities issuance and other regulatory proceedings. The FERC has vigorously regulated wholesale power transactions, including the growing use of regional power pools that have contributed to improved efficiency and lower rates. Very importantly, the SEC's requirement for full and current disclosure of all financial and operating data by publicly owned utilities and holding companies under the Securities Act of 1933 and the Securities Exchange Act of 1934 has protected utility investors from the abuses of the 1920's that led to PUHCA.

With the problems of the past eliminated, it is now appropriate to look at the effects of PUHCA on the present condition of the electric power industry and its future. Currently, under PUHCA, ownership of 10 percent or more of the voting securities of an "electric utility" will subject



any company, whether a utility or a non-utility, to the extensive regulatory requirements of PUHCA.

For IPPs, the practical effect of PUHCA is to limit operation and ownership to a single generating plant in a single state. In the case of a utility or an exempt utility holding company, this means that they may not invest in states outside their traditional service territory. If they did invest in a second generating plant in another state, they would be required to become a registered holding company. This would subject them to complex and detailed regulation of everyday financial and other aspects of their business. For example, SEC regulatory approval is required before any debt or equity securities may be issued. This time consuming process would prevent IPPs from meeting the pressures of the competitive marketplace. Also, PUHCA limits registered companies to a single line of business, the electric utility business. This effectively prevents other types of energy or energy related companies from participating and would defeat any attempt to rely on the IPP industry for a significant share of the nation's future generation requirements. Thus, for a number of reasons, few, if any, major investors in independent power projects would elect to subject themselves to this extensive regulation.

The only remaining option is to invest in independent power projects with highly complex and distorted capital structures that prevent the investing company from exercising voting power or managerial control. Obviously, this severely limits the flow of capital into IPPs since most companies insist upon direct control over the management of their assets and investments. Ironically, these complex capital structures - often called "PUHCA pretzels" - are exactly what PUHCA was intended to prevent.

#### The Solution to the Problem - PUHCA Reform

Title XV of the Johnston-Wallop Bill (S.1220) would effect a very narrow change to PUHCA by exempting certain IPPs from the ownership limitations of PUHCA. A statutory class of IPPs defined as "exempt wholesale generators" (EWGs) would be allowed to own facilities for the generation of electric energy exclusively for sale at wholesale without becoming an "electric utility" under PUHCA. The Bill exempts the EWG and its parent company from the strict ownership limitations of PUHCA.

The impact of this narrow change, affecting only corporate structure, would be to allow utility and non-utility entities to make substantial investments in IPPs in any state - wherever the need for power occurs. More

importantly, utilities would have significant new supply options. They could select from a greater array of purchase choices based upon the lowest price and other factors necessary to assure financial and operational reliability. They will also be able to preserve their option to construct new generation capacity if, in their own opinion, it provides a lower cost or more reliable source of generation.

It must be stressed that a utility's decision of whether to purchase from an IPP or construct itself is completely voluntary. Nothing in the PUHCA amendment would force utilities to do anything. Those utilities and state regulators who prefer to rely on traditional cost-of-service rate regulation for the development of new generation capacity may do so. PUHCA reform merely permits those utilities and regulators who wish to pursue non-rate-based options such as competitive bidding and IPP development to do so.

#### Benefits of PUHCA Reform

It should be pointed out that PUHCA reform is merely a logical extension of the ongoing structural and regulatory changes occurring in the electric industry today. In recent years, state and federal policy makers have embraced policies to promote greater competition in the wholesale

generation market. At least 26 states now have some form of competitive bidding for new generation in effect or under consideration. This compares to only a handful of states just a few years ago. By allowing a vital, growing independent power industry to develop in this new competitive regulatory context, PUHCA reform will inevitably result in lower future generating costs for utilities and their customers.

A recent Department of Energy cost-benefit analysis has estimated that the minimum benefit to consumers will vary between \$300 million and \$1.8 billion per year by the year 2000, depending upon the amount of new capacity met through competitive procurement. The present value of this stream of benefits to consumers over the 1991-2000 period varies from \$871 million to \$5.226 billion.

#### Consumer and Investor Protection

PUHCA reform is not deregulation. State and federal retail and wholesale rate regulation and securities laws remain in full effect without any change. The Johnston-Wallop Bill contains a series of provisions that reinforce and expand the powers of state commissions to protect consumers. Thus, consumer protections are enhanced by the

11, not diminished as some have contended. Specifically, the Bill protects ratepayers in the following ways:

1. State commissions are expressly granted the authority to allow or disallow the cost of any wholesale power purchase from an EWG on the grounds of prudence or imprudence. This authority is granted in order to prevent any federal preemption of state commission authority under certain prevailing Supreme Court and other Court decisions (Sec. 15105).
2. State commissions are authorized to evaluate any potential increases or decreases in the cost of capital of the purchasing utility or increases or decreases in rates resulting from a wholesale power purchase from an EWG (Sec. 15107).
3. State commissions are authorized to evaluate any negative or positive effects on reliability of electric service and any unfair competitive advantage resulting from the capital structure of the EWG selling to the utility (Sec. 15107).
4. State commissions are granted access to all relevant financial information and other records

and contracts of EWG's as if it were a utility subject to its jurisdiction. This enables the state commission to police any alleged self-dealing abuses and prevent any cross-subsidy of an EWG (Sec. 15108).

It is instructive for the Congress to note that Mr. Steven Fetter, Chairman of the Michigan Public Service Commission, testified on May 2, 1991, before the House Subcommittee on Energy and Power, in favor of PUHCA reform provided adequate safeguards are included to ensure that subsidies or self-dealing do not occur and that state regulators have a prudency review.

Each of the consumer protections referred to by Chairman Fetter are covered by the provisions of the Johnston-Wallop Bill which I have just described.

When viewed properly, PUHCA reform is not deregulation of the generating segment of the electric power industry. It is allowing vigorous competition within the existing state and federal regulatory system protecting consumers and investors.

Rebuttal of Opponents Arguments

Admittedly, PUHCA reform has opponents within the utility industry that seek to preserve the status quo, even though the enhanced option for these utilities to purchase wholesale power from ENG's is completely voluntary. These utilities make a number of arguments that need to be rebutted on the record. Their arguments and our response are as follows:

1. Argument

Allowing independent wholesale power generation to develop will reduce the overall reliability of electric production because IPPs will not have the expertise, experience or financial strength of utilities.

Response

First, there is plenty of data to demonstrate the high level of reliability of independent power plants built under PURPA. Furthermore, the vast majority of investors in the IPP/cogeneration business are substantial energy companies. Many are affiliates of some of America's largest corporations -- with considerable experience in energy project. These include utility affiliates,

power plant equipment vendors, architects/engineers, and gas pipeline companies. Affiliates of companies such as General Electric, Dow Chemical, Westinghouse, Fluor, Bechtel, CMS Energy, Southern California Edison, Enron, Coastal and many others are the established leaders in the independent power business. These companies are experienced and their plant operating records are excellent.

Second, standards for power plant reliability and related factors are controlled by the purchasing utility contracting power from the IPP. The utility can require in its power purchase specifications anything it wants regarding plant quality and reliability, and thus has primary control in determining the quality of its contract power capacity. Furthermore, wholesale power generators are generally paid only for power they are able to deliver or make available; therefore, they have at least as strong an interest in reliability as utilities and consumers to prevent extended outages.



2. Argument

Amending PUHCA will force utilities to purchase unneeded power or power at higher costs than can be provided by utilities.

Response

Unlike PURPA, PUHCA reform is totally permissive and does not force any utility to purchase power from any source. As explained above, it expands a utility's options which will result in more competition and lower rates. Likewise, nothing in the amendment would empower state PUCs or others to require purchases from IPPs by a utility.

3. Argument

Promoting an independent power industry for electric generation by amending PUHCA would effectively eliminate the obligation to serve, which has been a cornerstone of the utility industry.

Response

Natural gas distribution utilities have obligations to serve just as electric distribution utilities, yet they rely heavily on gas suppliers. In the natural gas industry, there are distinct

segments of gas distribution, gas pipelines (transmission) and gas producers. Under the Holding Company Act, only gas distribution companies are jurisdictional, while transmission and production are not under PUHCA. Furthermore, gas distributors purchase virtually all of their gas under contractual relationships with pipelines and producers without diminishing their obligation to serve. Likewise, an electric distribution company would have no less an obligation to serve its customers if it purchased some, or even all, of its power from wholesale generators. In fact, there are many electric distributors, small and large, as well as municipals and cooperatives who already purchase under long-term contracts significant quantities of power from other generators. Thus, it is inconsistent to argue that purchases from IPPs will somehow alter a utility's obligation to serve, whereas existing purchases from others do not. If a utility is concerned about its ability to service its customers with purchased power, it will simply elect to build and not buy.

#### 4. Argument

Amending PUHCA to allow greater and less restricted ownership of new power generation effectively deregulates the electric industry leading to a severe loss of regulatory oversight that could result in another "savings and loan" type crisis.

#### Response

The proposed amendment to PUHCA is very narrow and does not remove any registered or exempt utility holding company from the purview of the SEC under PUHCA. It simply assures that mere ownership of new IPPs does not constitute a reason to be regulated under PUHCA.

Furthermore, as I have stated before, the proposed PUHCA reform does not change or remove any authority to regulate electric rates either at the FERC for wholesale power sales and transmission or at the state PUCs in the case of retail rates.

Finally, the savings and loan crisis came about because of large federal financial guarantees of the saving and loan industry and inadequate scrutiny of S&L investment practices. In the case

of IPPs or the utilities they supply, there are no federal or state financial guarantees that could result in such a taxpayer burden. Also, state and federal utility and securities regulation will keep all aspects of each IPP in the public eye for all to scrutinize. Moreover, there is nothing in the proposed PUHCA amendment which would weaken utilities. Rather, the amendment could strengthen utilities by reducing their future exposure to power plant construction risks.

5. Argument

The proposed PUHCA amendment would preempt state regulatory authority and shift more power to the federal government.

Response

There is nothing in the proposed amendment that diminishes the current authority of states to regulate electric utilities. All the state authority that currently exists will continue to exist. In fact, as I have stated earlier, the Johnston-Wallop Bill reinforces state regulatory authority in a number of respects.

All retail rate matters will continue to be regulated by the state and all wholesale rate matters will continue to be regulated by the FERC. Furthermore, states continue to be free to enact whatever statutes they deem to be necessary for their PUCs so long as they do not conflict with federal jurisdiction over wholesale power transactions.

6. Argument

IPPs cannot build power plants any cheaper or any better than utilities; therefore, there is no need for them and government policies should not encourage them.

Response

This is always the argument of those who do not want competition or who fear it. If utilities really can always build cheaper and better power plants, then those who support this traditional approach to providing new generating capacity should have nothing to fear from IPPs, for these utilities would always prevail. The fact is, however, that competition is healthy and generally ensures that the consumers are getting the best value.

In many cases, IPPs can and will provide the best alternative and should at least have the opportunity to compete.

7. Argument

Firm contracts for power from IPPs allow for too much financial leverage of the IPPs and become the basis for IPP's credit at the expense of the purchasing utility's balance sheet.

Response

In structuring the contractual terms for a power purchase from an IPP, utilities have complete freedom to determine the power contract conditions, including the financial leverage used by the IPP. If a utility is concerned about these matters, it need only require that the IPP meet certain financial integrity tests. It is important to note that it is the purchasing utility that establishes the ground rules for IPP contractual terms, not the IPP. With PUHCA reform, larger, well financed companies will be able to compete and the financial risk issue rising out of the obligation to purchase from small, start-up QFs under PURPA will disappear.

Consumers Power's experience proves the point. With the completion of the Midland Cogeneration Venture's 1340 megawatt cogeneration plant which provides 1240 megawatts of capacity to Consumers Power, a substantial portion of Consumers Power's total capacity is now acquired through this wholesale power purchase. Without this purchased power, Consumers Power would have no reserve margin. Despite this reliance on wholesale power purchase from an IPP, all the major rating agencies have upgraded Consumers Power's bond ratings two grades since the commencement of construction of the plant. It is highly doubtful that either of these upgrades would have occurred if Consumers Power would have constructed and financed the plant itself.

Financial risk to utilities and their ratepayers can be controlled in many ways. By requiring conservative balance sheets, pre-construction financing commitments, construction contracts with fixed price and guaranteed completion provisions, long term fuel commitments and other performance guarantees, the purchasing utility can place the risks on the IPP along with a strong incentive to meet the utility's conditions to signing a power

purchase agreement. Insisting upon only dispatchable power purchase obligations without any significant minimum purchase commitments or take-or-pay obligations will also put the operating risks on the IPP. With this approach, there is no reason why rating agencies, investment bankers or institutional investors would find any adverse effect on the purchasing utility's credit.

#### Issues that Should Not be Included in Legislation

Some have suggested severe or even total ownership restrictions on utility affiliates qualifying as IPPs in the utility's own traditional service area. Such a restriction would be both unfair and harmful to electric consumers. By barring a utility affiliate from the competition, consumers may be seriously harmed by eliminating one of the strongest and most experienced competitors. There are no ratepayer advantages to eliminating competitors of any kind.

It should be noted that sufficient authorities already exist, at both FERC and state public utility commission levels to ensure that no affiliate-related abuses occur. In fact, as explained above, the Johnston-Wallop Bill clarifies and expands the authority of state commissions to prevent self-dealing abuses and cross-subsidies.



In approving IPP wholesale rates, FERC has a responsibility to ensure "just and reasonable" wholesale rates. If a competing IPP offering better terms is unfairly squeezed out by an affiliated IPP, there is ample opportunity under existing law for the FERC to disapprove the proposed transaction with the utility affiliate. Furthermore, states have the ratemaking authority to ensure that utilities can be penalized for power contracting practices which are determined to be injurious to consumers.

#### Transmission Access

A final issue relates to transmission access. Some suggest that you cannot have competitive wholesale generation without broad mandatory transmission access legislation. I do not agree with that.

Access to a purchasing utility's transmission system is obviously essential for an IPP. However, I am unaware of any situation where an IPP has been excluded from a utility's competitive power procurement process by a failure to obtain access to its grid. Purchasing utilities have every reason to voluntarily open their grid so they can select the lowest cost option. Their state public utility commissions will require the same under prevailing "least

cost" regulations and policies. Likewise, if the IPP and purchasing utility seek support before the FERC for a "market based" rate as "just and reasonable" under the Federal Power Act, the FERC will normally require open access in order to find that a workably competitive bulk power market exists. FERC has recently also conditioned its approval of utility mergers and acquisitions on an open transmission system by the merging utilities.

Thus, as a practical matter, a combination of voluntary access granted by utilities and FERC's conditions for approving market based rates and utility mergers have created an open grid enabling "free entry" into the wholesale power market for all IPPs. Mandatory access legislation is not necessary at this time.

Under a system of voluntary access, utility management will be able to control the operation of the grid in order to assure reliability of service to its native load customers. Also, the FERC will be able to review all cost allocations and rate designs applicable to the grid under its current rate making authority. This will protect native load customers from any current or future adverse rate impacts resulting from new users' access to the existing grid and any upgrades of it.

If the current system of voluntary access under the existing provisions of the Federal Power Act proves inadequate to the task, the Congress should address the issue when specific problems are identified. The voluntary system should be given a chance to succeed first. If, on the other hand, transmission legislation in the Congress is introduced in connection with PUHCA reform, we would like the opportunity to express our views. It is very important that transmission legislation contain appropriate protections for the economic interest of native load customers and the reliability of service to all customers, as well as allow the growth of an independent power industry.

In Michigan, Consumers Power Company has had a history of successful operation of our transmission system which is operated as a pool with Detroit Edison's transmission facilities. As a result of a settlement agreement entered into in the 1970's under the anti-trust provisions of the Atomic Energy Act, Consumers Power's transmission system has open access. We have never denied service under our FERC transmission tariff and we are currently planning to broaden the scope of the service offered in accordance with the request of some of our customers. Most importantly, the open access granted by Consumers Power to others has not affected the reliability of service to our native load

customers or the quality of service provided by the Michigan power pool. Our experience can be a valuable example of how open access can work in the best interests of utilities, their customers and new users of the grid.

#### Summary

In summary, Mr. Chairman, enactment of PUHCA reform is very much in the public interest because of the improvements in the competitive availability of wholesale power that would result. The legislation is simple in its scope. It does not compel any utility to do anything -- and certainly nothing that would harm customers. To the contrary, enactment of PUHCA reform would help the system work better by providing new options for the benefit of the electric consumer.

Thank you very much.

PALMER  
BELLEVUE  
CORPORATION

***PUHCA REFORM: EXPLODING THE MYTH  
OF DEREGULATION***

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### **A PERSONAL PREFACE**

Typical of a controversy on the verge of decision is the emergence of attenuated analogies to other situations, facile labelling designed to evoke emotional rather than intellectual response and a frenzied search for the "silver bullet" argument.

Some contend that revisions in the Public Utility Holding Company Act of 1935 (PUHCA) constitute "deregulation" because participation in independent electric wholesale generation projects would not trigger application of registered holding company controls by the Securities and Exchange Commission. This claim has been buttressed by a comparison of PUHCA reform proposals to regulatory and structural changes which have taken wrong turns in other industries. Some go so far as to charge that PUHCA reform virtually guarantees a wave of S&L-type insolvencies in the electric power industry.

The proponents should be thankful that the opponents have resorted to the S&L argument -- which is currently the political equivalent of putting on a Halloween mask and jumping out of a closet to shout "BOO." Once the recipient gets over the initial startle, the event is neither funny nor scary -- and the mask wearer seems a bit foolish.

My colleagues and I at Palmer Bellevue Corporation were asked, under a grant from the Utility Working Group which supports PUHCA reform, to assess the validity of the "deregulation" label as it has been attached to the two main PUHCA measures now before the House and Senate. The authors, however, are solely responsible for the opinions expressed in this paper.

I have a personal perspective on what constitutes "deregulation" in a regulated industry. As Illinois Director of Insurance and then as Chairman of the Illinois Commerce Commission (the state's utility regulator) during the first half of the 1980s, I actively promoted several major deregulatory efforts. These included price decontrol and decartelization of workers compensation

insurance, reliance on antitrust principles rather than rate regulation in property and casualty insurance pricing, progressive removal of Federal well-head price controls from natural gas, deregulation of competitive cellular telephone rates and regulatory forbearance on intrastate long distance telephone prices. As early as 1983, I became a primary voice within the ranks of state regulators urging significantly greater access to natural gas and electric transmission systems.

I was an early advocate of lifting traditional cost-of-service, rate-of-return regulation from electric wholesale transactions in which the buyer and seller can fairly negotiate price. I have also suggested the conversion of the Bonneville Power Administration from Federal ownership and control to ownership and control by BPA's traditional customers in the Pacific Northwest. My background as a financial solvency regulator, which includes chairing the major solvency and accounting committees of the National Association of Insurance Commissioners (NAIC), gives me a solid basis to evaluate whether PUHCA reform bears any similarity to the deregulation of financial institutions as some have claimed.

More recently, my credentials as a "deregulator" were accepted by no less than the Congressional Research Service in its report to the House Committee on Energy and Commerce entitled Electricity: A New Regulatory Order? One of the six models used in the CRS report to illustrate possible "market force" regimes for the electric industry is the "O'Connor model," a ten point plan for a transition from the current industry structure and regulation to one characterized by market determined prices for electricity and market-based decisions on capacity addition and usage.<sup>1</sup>

I know deregulation when I see it. The PUHCA revisions represented by the main proposals pending in the House and Senate as of this writing simply do not constitute deregulation. Rather, they seek to adapt conventional regulation to changed conditions. This paper represents the analysis which led to that conclusion.

Philip R. O'Connor, Ph.D.

Chicago, Illinois  
September 10, 1991

Palmer Bellevue Corporation



## **EXECUTIVE SUMMARY: PUHCA REFORM – EXPLODING THE DEREGULATION MYTH**

PUHCA reform is now on a path that reflects the evolutionary model recommended by the Congressional Research Service in its June 1991 report on the adaptation of regulation to changes in the electric industry market.

Rather than representing "deregulation," PUHCA reform is a modest redrawing of regulatory lines to bring developing activities in the electric industry clearly and decisively under the purview of traditional utility regulation.

The two primary PUHCA reform measures currently pending in Congress, the August 1 staff draft circulated by Chairman Sharp and Senate Bill 1220 reported out June 3, take a fundamentally conservative approach focused on the preservation and strengthening of the existing system of utility regulation. They attempt to hold the regulatory compact together by removing some of the points of abrasion which have developed between market conditions and regulation.

No one maintains that conditions in the electric industry are as they were in 1935 when PUHCA was enacted. Changes in technology, global energy markets, government energy policy and utility regulation at the state and Federal levels have produced a mismatch between market realities and PUHCA. It is appropriate for Congress to consider changing PUHCA to make it (and therefore overall utility regulation) more consistent with market developments.

PUHCA currently places severe limitations on the ability of state regulators, utilities and investors to adapt non-utility, non-PURPA generation as a component of least-cost and integrated resource planning policies that are receptive to competitive procurement of new power sources.

PUHCA currently creates the irony that while most electric utilities may diversify into virtually any non-electric business, they are largely foreclosed from diversification within the non-PURPA electric industry. Meanwhile, developers and investors are effectively prevented from significant participation in multiple non-PURPA wholesale power projects. PUHCA reform, instead of exposing the electric industry and its consumers to additional diversification risk, would permit utilities to diversify within the business they know best and have done well in. Non-utility parties would be permitted to participate in multiple non-PURPA wholesale power projects without triggering the registration provisions of PUHCA.

PUHCA reform would reconcile the mismatch of PUHCA and the market while adhering to traditional regulatory principles. The two bills refrain from mandating changes in the methods and mission of state regulation or the placement of any new obligations on utilities to purchase power from non-utility producers. Importantly, the "Pike County" doctrine under which states may judge the prudence of wholesale electric transactions is embodied for the first time in legislation. No currently regulated enterprises are relieved of regulation of their current activities because of PUHCA reform. In addition, no wholesale generator of electric power, whether a PURPA QF, a utility-owned plant or an independent power unit is relieved of any existing economic, rate regulatory or prudence oversight.

The proposed modifications merely provide a greater opportunity for the development of non-utility generators (NUGs) or electric wholesale generators (EWGs) while continuing -- and, in fact, extending -- the existing regulatory framework governing the U.S. electric utility industry. They would not mandate a change in the structure, organization, operation or regulation of electric utilities.

PUHCA reform adheres to established principles of utility regulation by:

- Maintaining a focus on restraining the potential for abuse of monopoly or market power;

- **Avoiding interference with the traditional discretion of state and Federal utility regulators in setting just and reasonable rates for electric power;**
- **Drawing clear jurisdictional lines between state and Federal regulation and removing opportunities and incentives for "forum shopping" by utilities and others;**
- **Supporting state authority over resource acquisition and the application of integrated resource planning by codifying the Pike County doctrine of state authority over the prudence of wholesale power purchases;**
- **Extending the Pike County prudence review power to cover purchases of wholesale power by utility subsidiaries of registered multi-state holding companies from affiliate and independent EWGs;**
- **Leaving untouched the ability of states to enforce quality of service and "obligation to serve" standards;**
- **Maintaining the roles of state utility commissions and FERC in the review of capital structures for effects on consumers and of the SEC in regulating the capital structure of registered holding companies;**
- **Conditioning the formation of new power pools or the spin-off of current utility generation units to EWG status under PUHCA reform on the prior consent of each affected state;**
- **Assuring state regulators access to books and records of utilities and EWGs in the exercise of traditional state authority over affiliate transactions; and**

**Maintaining state discretion to control utility diversification while creating the opportunity for utilities to diversify into the wholesale electric business without triggering PUHCA registration.**

Overall, state utility regulation is enhanced in the two PUHCA measures. First, the authority of states to disallow imprudent wholesale cost inclusion in consumer rates would be more clear and definite. Second, the reach of state regulation would be effectively extended well into the wholesale market. Third, Federal regulatory authority is not expanded at the expense of state authority.

The House and Senate PUHCA proposals adhere to the basic boundaries between state and Federal regulation by rejecting both an extension of the Pike County doctrine to utility affiliate transactions within a multi-state registered holding company and the creation of a new layer of utility regulation through regional interstate compacts.

The only aspect of the PUHCA reform package now under consideration that would alter a basic feature of utility regulation is the proposal in the House draft authorizing FERC to mandate transmission access for wholesale transactions. The transmission issue is distinguishable from PUHCA reform for the simple reason that the overall thrust of PUHCA reform is entirely permissive, not mandatory. Transmission access mandates would, however, vest genuinely new regulatory authority in FERC at the expense of the states.

To the extent that there is a desire to legislate with respect to transmission access in tandem with PUHCA reform, it would be advisable to design a measure that is consistent with the voluntary and state-oriented flavor of the Senate and House bills including provisions which encourage FERC to focus on the pricing issues to a workable system of voluntary transmission access.

PUHCA reform is a logical, evolutionary development flowing from more than a decade of change in the electric industry.

Further experience under the act may demonstrate that amendments are necessary.<sup>2</sup>

William O. Douglas<sup>3</sup>

## **INTRODUCTION**

Developments in an industry's market or technology periodically require that the boundaries of a regulatory framework be modestly redrawn. In the electric industry, the current debate over reform of the Public Utility Holding Company Act (PUHCA) is proceeding in the pragmatic spirit enunciated by William O. Douglas, Chairman of the Securities and Exchange Commission in the early years of PUHCA and one of PUHCA's architects. PUHCA reform in 1991 represents not revolution, but incremental improvement.

In the wake of the Gulf War and growing interest in the global environment, energy-related issues are at center stage on the 1991-1992 domestic policy agenda. President Bush's National Energy Strategy (NES) and a variety of proposals by members of Congress may lead to passage of major energy policy legislation in the 102nd Congress.

The President's NES is notable for its reliance on competition and market forces to set the course of national energy policy.<sup>4</sup> Electricity-related legislative proposals put forth by those critical of the NES also demonstrate confidence in the value of market forces and competition.

In recent years there has been much policy discussion, and a fair amount of action, regarding competition and the entry of new players into the electric power markets.<sup>5</sup> The electrical world is a different place than it was in 1935 when PUHCA was enacted.

The emergence of non-utility power generators as a major component of our electric resource base has stimulated substantial debate on two issues directly related to PUHCA.<sup>6</sup> The first issue relates to the proper role of non-utility power resources in the U.S. The second relates to the role of utilities or their affiliates in the non-utility power business, outside their own service areas where they have no market power or in their retail service territories. The current debate over revisions to PUHCA turns on these two issues.

PUHCA reform as now contemplated cannot possibly be categorized as "deregulation," as some have claimed. If it were, then virtually any regulatory change designed to meet new circumstances in any regulated industry could be considered "deregulation." The term then becomes meaningless as a way of distinguishing among competing proposals for change.

This paper considers two specific PUHCA reform proposals and their place in electric industry regulation in the United States. One is Title XV of Senate Bill 1220 as reported out by the Senate Energy and Natural Resources Committee on June 3, 1991. The other is the staff draft circulated August 1, 1991 by Congressman Phil Sharp, Chairman of the Energy and Power Subcommittee of the House Committee on Energy and Commerce. This paper also considers the transmission access provisions of the House staff draft, but separates that consideration from the specific PUHCA provisions of the draft bill.

### **WHY THE DEBATE OVER PUHCA?**

Many observers view the maintenance of PUHCA exactly in its current form as a barrier to achieving fundamental electric policy objectives. Proponents of PUHCA reform, ranging from the Bush Administration to non-utility generation firms and consumer advocates to established utilities, maintain that such regulatory goals as the provision of least-cost service may be hindered because PUHCA needlessly closes off valuable options and choices. Proponents of PUHCA reform contend that modest changes which permit greater opportunities for competitive wholesale power choices by local distribution utilities would be consistent with the maintenance of traditional regulatory goals.

PUHCA can indeed be changed to provide for greater freedom of choice in sources of generation, yet still continue to adhere to the goals of the Act's authors. Instilling investor confidence in the integrity of the securities issued by the integrated electric utility industry and protecting consumers from imprudent power transactions or inappropriate affiliate dealings are consistent with the proposed PUHCA reforms.

PUHCA, enacted in 1935, was designed to address problems of the day in the electric utility industry. PUHCA should not be viewed as having cast the structure of the electric power industry in concrete. Nor should PUHCA be thought to have closed off entry to each and every part of the industry forever. To the contrary, in order to maintain its status as a key component of the Federal-state fabric of utility regulation, PUHCA should periodically be re-examined to determine if PUHCA's individual provisions still meet the needs of the industry, consumers and the financial markets.<sup>7</sup>

Some current opponents of PUHCA reform have claimed that the proposals for PUHCA revisions now being considered in the House and Senate somehow constitute "deregulation." Specifically, opponents appear to contend that modification of PUHCA constitutes deregulation because substantial participation in non-PURPA independent electric wholesale generation

projects would not trigger application of the pervasive system of regulation by which the Securities and Exchange Commission (SEC) supervises registered holding company controls.<sup>8</sup>

Upon closer inspection, however, the proposals for PUHCA reform represent modest, narrow revisions of PUHCA which are clearly designed to serve as a component of an overall National Energy Strategy. The proposed modifications would merely provide a greater opportunity for the development of non-utility generators (NUGs) or electric wholesale generators (EWGs) while continuing -- and, in fact, extending -- the existing regulatory framework governing the U.S. electric utility industry. The proposed PUHCA revisions do not mandate a change in the structure, organization, operation or regulation of electric utilities. No currently regulated enterprises are relieved of any regulatory requirements with respect to their current activities. In addition, no wholesale generator of electric power, whether a PURPA QF, a utility-owned plant or an independent power unit is relieved of any existing economic, rate regulatory or prudence oversight.

Overall, the PUHCA reform proposals that are actively being considered in Congress constitute a modest and realistic reconciliation of the existing regulatory structure with market and technological changes, in ways designed to preserve the fundamentals of the existing regulatory system.



### **PUHCA: A BRIEF HISTORY**

Utility holding company systems emerged around the turn of the century and then grew rapidly during the 1920s.<sup>9</sup> Local electric companies were often unable to obtain the capital to purchase the generating and transmission equipment necessary to expand their ability to serve rapidly growing demand. Equipment companies such as General Electric and Westinghouse adopted the practice of accepting stock in a company as partial payment for goods or services.<sup>10</sup>

Some manufacturers of heavy electrical equipment, along with engineering and construction firms, and investment banks eventually formed utility holding companies to hold the utility bonds and stocks of the numerous utilities that they accumulated in the course of doing business.<sup>11</sup> Considering the rapid growth of the electric industry during that time and its capital intensive nature, these developments were entirely logical.<sup>12</sup>

A few of these holding company systems began to rapidly expand by simply "buying up whatever properties were on the market."<sup>13</sup> An extraordinary degree of concentration of electric utility ownership eventually resulted from the accumulation of utility securities by a few holding companies.

By 1929, roughly 80 percent of the nation's electric output was accounted for by operating utilities controlled by the 16 largest holding companies and the three largest systems -- United Corporations Group, Electric Bond and Share Company, and the Insull Group -- generated, transmitted, or distributed about 45 percent of the nation's electricity.<sup>14</sup> At its high point, for instance, the Insull Group controlled more than 12 percent of the country's electric business.<sup>15</sup>

The abuses which grew up in the utility holding companies are well documented.<sup>16</sup> These abuses included: 1) Pyramiding of control;<sup>17</sup> 2) Write-ups of assets and the manipulation of accounts;<sup>18</sup> 3) Payment of excessive dividends, unfavorable service contracts, and other forms of exploitation of operating companies;<sup>19</sup> and 4) Complex and highly leveraged financial

structures.<sup>20</sup> More generally, utility holding companies provided inadequate disclosure to investors of information needed to make an investment decision and tended to complicate or obstruct state regulation.<sup>21</sup> In addition, some utility holding companies were reported to pay exorbitant prices for utility properties in their rivalry to add to their systems.<sup>22</sup>

During the 1920s, the utility holding companies were flying high, along with numerous other stock market favorites of the time. But the 1929 stock market crash and the Great Depression began to unravel a number of the major holding companies. The extraordinary leverage used by the holding companies, costly service contracts between operating companies and their parents, and the highly inefficient, widely scattered holding company systems had built a "house of cards."<sup>23</sup>

The Insull empire was the first to crash.<sup>24</sup> By the time it was over, 53 holding companies went into bankruptcy, eventually leaving investors with only a small fraction of the original \$1.7 billion investment in their securities.<sup>25</sup> Other holding companies, while not falling into bankruptcy nevertheless experienced dramatic declines in their earnings.<sup>26</sup>

A critically important point, however, is that in spite of the financial disaster experienced by many holding companies and their investors and lenders, electric utility operating companies themselves weathered the financial and economic storm reasonably well.<sup>27</sup> In every case of the failure of a utility holding company, the underlying operating companies continued to function and to provide service.<sup>28</sup>

PUHCA of 1935 was a controversial and narrowly enacted nexus between the New Deal's financial markets legislation and its program on energy.<sup>29</sup> PUHCA's primary purpose, clearly stated in Section 1, was to:

Compel the simplification of public-utility holding-company systems and the elimination therefrom of properties detrimental to the proper functioning of such systems, and to provide as soon as practicable for the elimination of public-utility holding companies except as otherwise expressly provided in this title.<sup>30</sup>

PUHCA eliminated holding company abuses that had grown up within regulatory gaps. These gaps were largely the result of a combination of: 1) numerous corporate layers in many holding companies; 2) complicated inter-affiliate transactions between holding companies and operating companies that were widely scattered among many states; 3) weak state laws; and 4) rudimentary regulatory techniques at the state level. The most profound abuses affected investors. But ratepayers were not left entirely unharmed either.<sup>31</sup>

The complex corporate structures, which tied together utilities in many states under common ownership, placed practical limits on the ability of states to effectively control the issuance of securities based on the value or cash generating potential of the utilities under their jurisdiction. In the absence of adherence to standardized accounting and effective Federal securities laws (which would come only with the New Deal), holding companies were able to issue securities that proved to have little value.<sup>32</sup> Investors often had little information about what it was they were actually investing in. During the stock market frenzy of the 1920s, gullibility was not in short supply. The securities of several holding companies were sold door-to-door in small increments to customers of the operating companies. Many investors in the stocks and bonds of the holding companies, of course, lost all or nearly all of their investment.

Utility consumers suffered little in comparison to the eventual damage done to average holding company investors.<sup>33</sup> Nevertheless, state regulators of the day were probably at a disadvantage in insulating consumers from excessively costly service contracts and other types of affiliate transactions within holding companies or from the improper allocation of those costs among affiliate utilities in various states.<sup>34</sup> Many corporate layers and lack of adequate disclosure requirements served to shield the details of the transactions from review of regulators and investors.

The intent of PUHCA was to establish adequate Federal oversight of utility holding company systems beyond a certain level of complexity while leaving actual utility regulation to the states and to the Federal Power Commission, FERC's predecessor. Through PUHCA, the utility

properties formerly held by holding companies in a "helter-skelter" and "crazy-quilt" manner were simplified into coherent, geographically integrated utility systems.<sup>35</sup>

PUHCA required -- through Section 11, the so-called "death sentence" clause -- that the utility holding company systems reorganize into physically interconnected, coordinated and geographically integrated systems. The simpler entities that the implementation of PUHCA produced were more easily regulated by the state and Federal rate regulators of the day.

The "proof of the pudding" of PUHCA is that investors have substantial and reasonably accurate information available to them and that increasingly sophisticated state utility regulators and the Federal Energy Regulatory Commission (FERC) are not faced with serious corporate structure obstacles to the effective regulation of operating utilities.

In an important sense, PUHCA's job of dismembering the elaborate holding company systems was complete by 1960.<sup>36</sup> Since then, the SEC has played an ongoing, maintenance role.

The current controversy over PUHCA, while mild in comparison to that which attended its enactment and early implementation, does represent the most heated debate about PUHCA since its enactment. It is unlikely, however, that the PUHCA debate this time will contribute to producing a challenger for the White House, as it did with Wendell Willkie in 1940.<sup>37</sup>

Since PUHCA's enactment, there have periodically been proposals for revision, or even repeal. For the most part, these proposals were either aimed at greater efficiency in administering the law after its main goals had been achieved or to free registered holding companies from the constraints of the law, thus re-fighting the battle of 1935. The major changes discussed for PUHCA primarily involved either repeal or virtual repeal and/or the movement of the enforcement responsibility to an energy agency such as the Department of Energy or FERC.<sup>38</sup>

The current substantive and policy-based debate over PUHCA accepts the basic purposes of PUHCA and is only incidentally concerned with administrative efficiency. It is characterized by

fundamental differences of opinion within the electric industry, utility and non-utility, about how best to accommodate (or to resist) important changes that have taken place in the electric market.

**THE MISMATCH BETWEEN PUHCA AND THE ELECTRIC MARKET**

The PUHCA reform proposals now under discussion in Congress focus on bringing a very specific part of utility holding company regulation into line with the evolution of the utility industry. In its simplest terms, the specific mismatch between PUHCA and the evolving electric industry has two features.

First, utilities or their affiliates cannot easily invest or participate in non-PURPA wholesale electric power projects outside their home state without becoming registered holding companies.

Second, no non-utility party or group of investors can reasonably invest or participate in multiple non-PURPA wholesale power projects in more than one state. The many nuances and complexities involved serve only to exacerbate and make more unwieldy the current and growing mismatch.

The bottom line of the mismatch is that many utilities and their regulators, who are in the front lines of assuring reliable electric service at reasonable prices, believe that their flexibility to do the best possible job is hampered by the triggering of the registration requirements in the case of non-PURPA independent power projects. The remedy for the mismatch is not a complete revision of PUHCA -- or repeal -- but an evolutionary step which merely keeps pace with the evolution in the market of non-utility generation and clarifies and codifies any ambiguity in state power.

### **KEY ELECTRIC INDUSTRY TRENDS LEADING TO THE MISMATCH**

It is clearly appropriate for Congress to consider whether PUHCA requires some modest changes to make it (and therefore overall utility regulation) more consistent with market developments and with other public policies that have been implemented over the past two decades.

No doubt, others could cite their own list of trends and developments in the electric industry. One thing, however, is certain. No one maintains that conditions in the electric business are as they were in 1935 when PUHCA was enacted, or even a decade ago. This evolution is a function of: 1) changing technology; 2) changes in the global energy market generally; and 3) past public policy choices which have introduced new competitive features into the industry, most notably the Public Utility Regulatory Policies Act of 1978 (PURPA).

A brief examination of some of these trends will highlight some of these changes.

### **PURPA**

In the wake of the oil crises of the 1970s and the resulting concerns about fossil fuel availability and prices, Congress passed several measures which would prove to have long-lasting effects on the electric industry. In 1978, PURPA was enacted primarily to encourage energy efficiency and conservation and to refine Federal and state regulation of electric energy. Included in PURPA were provisions intended to encourage the use of alternative (waste or renewable) fuels and/or cogeneration (the simultaneous production of electricity and useful thermal energy), creating a new market niche.

PURPA has proven to be a critical first step in increasing competition in the U.S. electric generation market. PURPA has provided a gateway for new players to enter the electric industry and therefore has been an important incubator of competition in the electric utility industry.<sup>39</sup>

PURPA exempts "Qualifying Facilities" (QFs), either cogenerators or small power producers, from PUHCA and from regulation as electric utilities under Federal and state utility laws and in this sense represents important PUHCA reform. Thus, PUHCA is not a barrier to entry for these new market participants.<sup>40</sup> Indeed, a recent U.S. Court of Appeals decision highlights the advantage that QFs have by noting that:

Such advantage as a QF may have stems directly from the Congress's policy choice to encourage the sale of power by QF's rather than by traditional utilities.<sup>41</sup>

Largely because of PURPA, cogeneration and small power facilities account for about 35,000 megawatts of electrical generating capacity,<sup>42</sup> roughly equivalent to 35 conventionally-sized nuclear power plants or about five percent of total U.S. installed capacity.<sup>43</sup> Indeed, almost 50 percent of new capacity in 1990 was from QFs.<sup>44</sup>

The most important advantage that PURPA provides QFs is that utilities are obliged to buy power from QFs at avoided cost (the cost which the utility would otherwise incur if it were to generate the power itself).<sup>45</sup>

Some utilities have contracted to buy power from QFs that they do not need or at prices that now seem uneconomic. This occurred for a variety of reasons including: 1) the manner in which state public service commissions calculated avoided costs; 2) inaccurate fuel cost and capacity need projections by utilities; or 3) state laws that set high minimum QF rates. It is important to note, however, that virtually all of these problems are the result of state implementation of PURPA, not the mandates of the law itself. Many states have not encountered these problems.

As discussed in greater detail later in this paper, the types of generation covered by PUHCA reform proposals (whether called EWGs, IPPs or NUGs) will not enjoy the "favored nation" features that have provided clear advantages to QFs.



### "Excess Capacity" and Wholesale Competition

A key feature of the electric industry in recent years has been the emergence of a more competitive wholesale market. Contemporaneous with the rise of the PURPA QF industry as an alternative source of power, many utilities were completing major construction projects begun before the sharp decline in electric demand precipitated by the oil shocks of the 1970s and the recession in the early 1980s. Utilities often found themselves with ample temporary reserve margins, sometimes less charitably called "excess capacity."

Exacerbating the problem was the fact that the trend of the cost line in the electric industry reversed itself in this period. Previously, electricity had been a declining cost business with each new increment of capacity coming into commercial operation at a lower cost per kilowatt-hour than the previous increment. This had been achieved by economies of scale, improved technology, high growth in demand, low inflation and interest rates and stable fuel prices. All of that changed. In addition, new environmental requirements and regulatory-related delays in the completion of nuclear plants made many new plants very expensive.

In some cases there was a "double whammy." Not only was the new generating capacity far greater than needed in the near-term, but that capacity was often very expensive. At this point, in the view of many, the implied regulatory compact began to unravel. Faced with significant rate increases many state regulatory commissions chose to disallow hundreds of millions of dollars in plant costs from recovery in rates, or "phased" costs in over many years.

In the end, the electric industry proved to be no more immune to the effects of consumer response to price increases and surplus than other industries have been. While the surplus itself was temporary, the activity in the wholesale market that it stimulated has triggered a continuing interest by many utilities and regulators in wholesale transactions as an important part of meeting electrical demand.

### Competitive Bidding

The availability of non-utility sources of generation has engendered a rapidly growing interest by state regulators and by many utilities in various forms of "competitive bidding" to serve incremental power generation needs. Competitive procurement is becoming an established feature of the power markets.

An important event in framing thinking about competitive bidding in the power industry was the 1988 FERC Notice of Proposed Rulemaking (NOPR) which suggested that wholesale power sales made through state supervised bidding programs be largely relieved of the requirement to seek Federal rate approval. While the NOPR did not advance beyond the proposal stage, it is clear that it had a dramatic impact in terms of framing the debate which has proceeded since.<sup>46</sup>

### Least-Cost Planning and Demand-Side Management

Many states, often in tandem with an interest in competitive bidding, have joined a movement toward "least-cost" or "integrated resource" planning.<sup>47</sup> Under this approach, utilities are obliged to consider all appropriate alternatives for meeting their customers' needs -- including both demand and supply-side options -- before beginning to build or acquire additional generating capacity. Dr. Mark N. Cooper, of the Consumer Federation of America, argues that the "organizing principle" for structuring the electric utility industry in the future and which PUHCA "reform must reinforce are integrated least cost resource planning and competitive bidding to fulfill these plans."<sup>48</sup>

Demand-side management includes energy conservation and load management (such as energy efficient lighting and thermal energy storage, respectively) to reduce the need for capacity and/or energy.<sup>49</sup> Many states now require utilities to consider demand-side options on a level playing field with supply-side options. More importantly, states have begun to provide economic

incentives in order to encourage utilities to pursue more aggressive demand-side management programs.

### The Impending Need For New Capacity

Electrical power demand is likely to continue to enjoy a positive correlation with general growth in the economy. Electricity usage has increased strongly during the 1973 to 1988 time period even as total energy consumption has increased slightly. Electricity usage grew at an average rate of 2.7 percent per year -- slightly exceeding GNP growth during the 1973 to 1988 time period.<sup>50</sup>

Predictions by some experts in the mid-1980s that demand for electricity would level off or decline have proven dramatically incorrect.<sup>51</sup> As the economy grows, we can expect an increasing demand for electricity because of its versatility and convenience. The inescapable conclusion is that important decisions about the mix of new generating capacity and demand-side capability will have to be made in many areas of the country during this decade.

Until utilities decide whether to commit their own capital to new generating plants, they will, in general, be generating more cash from their business operations than they will need for investment in upgrading transmission and distribution systems and for normal shareholder dividends. As is customary following a construction cycle in the electric industry, utilities are using cash to retire debt and to strengthen their balance sheets by increasing the equity components in their capital structures. Importantly, unlike past periods, many utilities may wish to have the readily available option of foregoing commitment of their own capital to power plant construction and ownership. They may choose to rely on alternative sources of power.

To the extent that a utility or its regulator has a preference for purchased power, utility capital would not be directly invested in generating capacity to serve load. That leaves the question of what (or whether) investment will be made to grow the underlying book value of the stock.

### Practical Limits For PURPA QFs

As utilities consider new power sources, including non-utility power which has been legitimized by the market and the law, opportunities for additional PURPA QF facilities have become increasingly limited. In some areas of the country the number of potential "steam hosts" required for meeting the energy efficiency standards contemplated in PURPA is thought to be significantly diminished.<sup>52</sup>

This is important for two reasons, one quite substantive, the other for what it illustrates about the growing PUHCA mismatch with the market.

The substantive point is that to the extent there is a market demand for non-utility power sources to serve part of the growing demand for electric power, the primary PURPA option may grow scarce. If PUHCA effectively limits non-PURPA, non-utility power project development because the "registration risk" deters both utilities and independent developers, then there could be the unintended creation by regulation of a shortage of something that the market wants -- reliable electric generating capacity and energy.

The illustrative point is that some observers suspect that the PURPA steam host shortage is being "cured" in some cases by the invention of a steam host for the sake of the power project rather than the creation of the project for the sake of the host. Increasingly, it appears that some PURPA cogeneration facilities are being built and operated, often with the encouragement or acquiescence of the purchasing utility, in ways which make only the most minimal use of the steam in a process application. In short, a PURPA facility, even with a "Potemkin village" steam host created to qualify under PURPA, may be more attractive economically to a utility than a utility-owned plant. If this is true, it follows that an attractive non-PURPA power plant will be even more economically attractive to the utility than a PURPA "machine."

While there is an increasing desire to make continued use of non-utility power sources, some of PURPA's requirements may be hindering the realization of the abundant efficiencies that were originally desired. PURPA's requirements may impose additional costs compared to those which might be incurred by an independent power unit absent the steam host.

#### PUHCA "Pretzels"

An important indicator that PUHCA has developed a certain mismatch with the demands of the market and with its own objectives is the emergence of the "PUHCA pretzel." There are now several instances in which the SEC has granted exemptions to non-PURPA, non-utility affiliated electric wholesale projects. In these cases, elaborate and ingenious efforts have been made by the developers, their lawyers and the regulators to devise corporate and financial structures which can pass through the "eye" of the PUHCA "needle" and avoid classification as a registered holding company.<sup>53</sup>

**PUHCA REFORM AND THE PRINCIPLES OF UTILITY REGULATION**

A clear distinction should be made between "utility regulation" and "holding company regulation" under PUHCA. The SEC has no ratemaking authority and PUHCA does not regulate electric utilities. Rather, PUHCA regulates the corporate form and financial transactions of certain registered electric or gas utility holding companies.

Utility operations, rates, quality of service and most inter-affiliate transactions of electric utilities are regulated by state regulators at the intrastate retail level under state laws. FERC regulates wholesale transactions, primarily under the Federal Power Act.

Nothing in the two primary PUHCA reform measures pending before Congress alters the basic features of electric utility regulation in the U.S. If anything, the PUHCA reform provisions are an attempt to hold the regulatory compact together by removing some of the points of abrasion which have developed between market conditions and regulation at both the Federal and state levels. PUHCA reform does not abrogate the assumed regulatory compact. Rather, it strengthens and reinforces it.

An examination of PUHCA reform proposals reveals an attempt to remain true to well-established utility regulatory principles in the face of changing circumstances. Adherence to regulatory principles should not be confused with a blind loyalty to specific regulatory methodologies, irrespective of changed conditions. Nor should there be an assumption that today's companies and corporate structures are the only possible ones for the future.

The electric industry continues to evolve. The regulatory framework has always evolved while managing to adhere to basic principles. To contend that PUHCA, written over half a century ago, should be considered immutable would be to ignore the basic realities of the electric industry of today. Just as PUHCA was a product of its time, so, too, should PUHCA reform.

The key to evaluating the allegation that PUHCA reform is tantamount to deregulation is to determine if the PUHCA reform proposals violate established goals and principles of utility regulation. Indeed, it is legitimate to consider the extent to which PUHCA reform actually could reinforce and reaffirm traditional regulatory goals.

### **Restraints on Market Power**

Utility regulation is not so much predicated on a commitment by government to enforce a system of vertically integrated, locally franchised monopolies as it is designed to place restraints on the ability of such a system to abuse its market power. In fact, utility regulation fully acknowledges the possibility of competition and of segmentation in the industry, with different firms and organizations performing different functions at times, whether generation, transmission or distribution.

It is not necessary to resolve in this paper the issue of the extent to which some aspect of electric service provision may be a "natural" monopoly which optimizes efficiency and costs as a result of the government's enforcement of the monopoly and is therefore regulated to prevent market abuse.<sup>54</sup> For purposes of a discussion of PUHCA reform, only the obvious need be stated. First, local distribution is almost always a franchised monopoly. Second, there are significant limitations in transmission capability such that transmission is likely to continue to exhibit monopolistic features. Third, generation is demonstrably not a monopoly.

Generation cannot be considered part of a "natural" monopoly. Wholesale power transactions have always been a feature of the electric industry. Arrangements among and between vertically integrated utilities, local electric distribution entities (often government owned) and enterprises involved exclusively in the generation of power (e.g., generation and transmission cooperatives serving rural distribution cooperatives and Federally owned and operated power marketing agencies) are ubiquitous.

The two primary PUHCA reform proposals take the world as it is, characterized by a high degree of regulated monopoly in distribution and transmission coexisting with the increasingly competitive wholesale power market. They both provide some modest room for the industry to develop in the direction of a more competitive market for wholesale power, if that is what utilities and their state regulators want in the future.

Neither of the two main PUHCA bills removes or alters the ability of electric regulators to "insulate" consumers from the exercise of monopoly or market power in any segment of the industry. If anything, the bills grant clear and unequivocal authority to state regulators to more closely oversee and control wholesale power purchase decisions by utilities under their jurisdiction, even when the utilities can choose among competing power sources which themselves have no market power.

### Rate Regulation

The primary method by which regulators at the state and Federal levels exercise their responsibility has been rate regulation. State regulators and their Federal counterparts have plenary control over rates and generally have authority to require prior approval before any rate or tariff is implemented.

In general, electric rate regulation has been based on "rate-of-return" or "cost-of-service" regulation. These methods set a targeted annualized revenue level ("revenue requirement") for a utility, taking into account the company's actual or anticipated operating expenses, projected sales levels, funds required for debt service and a return on equity capital. The equity return on capital invested in "rate base" (e.g., power plants, transmission lines, etc.) is supposed to approximate that which investors could expect to earn in a business of similar risk.

Utility regulators have substantial discretion in the methodologies they use to estimate a utility's revenue requirement. Regulators also have substantial discretion in their evaluation of the facts



which lead to the determination of the revenue target and the profit level that is considered to be fair and reasonable.

In addition to regulating the overall revenue level, electric utility regulators decide how the costs will be allocated among customer groupings and types. Regulators also decide what each and every separately priced service will cost whether at wholesale or retail. Regulators can also set the terms and conditions under which the service will be provided.

Neither of the PUHCA reform bills impede state or Federal regulators in the exercise of traditional rate regulation nor in the selection of the methods to be applied in making their decisions. Nor do the bills alter the reality that regulators cannot be compelled to accept "market-based" pricing proposals rather than to choose the imposition of traditional cost-of-service rates on both buyer and seller. The PUHCA bills in no way deregulate wholesale electric prices and make no presumption as to what methods regulators will apply in approving wholesale or retail prices.

#### Clear Lines of Federal and State Regulatory Jurisdiction

Until recent times, there was relatively little controversy over the respective electric utility regulatory jurisdiction by the FERC and state public service commissions. FERC regulates wholesale power rates and rates for transmission service provided by utilities to other utilities. State public service commissions regulate retail rates for end-use consumers and have set the avoided cost rates which utilities must pay for PURPA QF power.

The primary controversies between the two levels of regulation have come in the context of fairly conventional situations rooted in PUHCA as it is today. FERC has been criticized for permitting arguably excessive rates by one utility for power sold to another or for allocating allegedly excessive allocations of allegedly excessively expensive power plants among companies within the same multi-state registered holding company.<sup>55</sup>

The core of the controversy is that it has generally been held by the courts that a state regulator must permit recovery of revenue at retail those costs incurred in a wholesale power purchase where FERC has determined the charges at wholesale to be just and reasonable.<sup>56</sup>

The complicating dimension in the controversy has been the issue of the extent to which the state regulator may deny recovery of wholesale costs which have been imprudently incurred by the local utility. While the actual price of the power may be "just and reasonable" under traditional FERC-administered rate-of-return regulation, the purchasing utility may have made a bad choice in deciding to buy the power, perhaps because there was no need for the power or because there were other readily available supplies at more attractive prices or terms. This ability of the state to assess the prudence of a wholesale purchase by a utility has been called the "Pike County" doctrine.<sup>57</sup>

Most state regulators have expressed an interest in the maintenance or enhancement of the "Pike County" doctrine.<sup>58</sup> This desire is entirely understandable, since reviewing the prudence of a wholesale power purchase is merely an extension of the established authority of state regulators (e.g., reviews of power plant construction decisions and implementation or fuel purchase decisions).

It has been alleged that PUHCA revisions would permit utilities to enter into imprudent wholesale transactions with EWGs, the costs of which state regulators would then be obliged to pass on to retail customers. Such an outcome is impossible under the two PUHCA measures now pending in the Congress.

State regulators will be able to exercise clear authority to insulate consumers from imprudent wholesale transactions with EWGs. Further, both PUHCA bills take steps to incorporate the essence of the Pike County doctrine into law with respect to more conventional wholesale market transactions as well with EWGs, thus clarifying and codifying a somewhat ambiguous state power which relies on a court decision.

If enacted, the PUHCA reform proposals would significantly clarify the allocation of responsibilities between state and Federal regulators, with state regulators gaining considerable additional authority. Re-establishing clear lines of authority will substantially remove the incentives, as well as the opportunities, for "forum shopping." One complaint of state regulators about the allocation of authority between the state and Federal levels has been that there are gaps or ambiguities which may encourage some in the electric industry to seek Federal jurisdiction over their actions in the belief that the treatment may be more favorable.<sup>59</sup>

The real problem is the potential for divisive jurisdictional disputes which tend to make even more convoluted an increasingly complicated regulatory environment. The PUHCA reform proposals, by establishing clear lines of regulatory responsibility with respect to EWGs, largely eliminates not merely the reality of certain jurisdictional problems but the even more damaging suspicious anticipation by state regulators that utilities and others may attempt to escape state regulation.

Additional evidence of the effort in PUHCA reform to draw clear, bright regulatory lines is that the Senate bill provides the opportunity, with state commission approval, for existing PURPA or PUHCA pretzels to convert their status to that of EWGs.

#### State and Utility Control Over Resource Acquisition And Prudence Reviews

The specific provisions of the two pending PUHCA bills which clarify and strengthen state regulatory authority are rooted in the authority state regulators have over resource planning and resource acquisition by utilities. This authority has been increasingly formalized by least-cost and integrated resource planning statutes and procedures in many states. Both PUHCA bills reinforce the ability of states to require utilities to comply with state least-cost planning.

The least-cost planning process is, among other things, an effort to move more of the prudence review process up-front and before the fact, rather than waiting until a utility actually seeks to

include recovery on a new power plant in its rates. In recent years, a number of utilities have suffered severe financial hardship because their state commissions have disallowed large portions of the costs of new power plants.<sup>60</sup> Up-front prudence reviews are designed to create greater certainty for investors, utility management, regulators and consumers by setting limits on financial recovery for specific resource acquisition projects. Rolling prudence reviews, which would allow a periodic review of the need for a project, have also been proposed. In these ways, important decisions are not put off until a date, very far in the future, when the regulators originally involved in decisions are no longer around.

Least-cost planning is also an effort to better match resource acquisition to customer demand and to incorporate a consideration of demand-side options into the resource base. Much of the motivation for least-cost planning is the desire to find ways of avoiding repeats of the "excess capacity" and "rate shock" situations of the recent past.<sup>61</sup>

The two PUHCA bills accommodate and support least-cost planning and up-front prudence review in several specific ways.

- The Senate and House bills specifically ensure the right of a state to disallow the inclusion of imprudently incurred costs of a wholesale power transaction in retail rates.<sup>62</sup> Federal pre-emption is possible only in the case of the allocation of utility-owned plant costs among the operating affiliates of a registered holding company.<sup>63</sup>
- The same Senate and House sections noted above grant plenary authority to the state to disallow imprudently incurred wholesale power costs, whether for power purchased from an EWG or a utility.
- The Senate bill provides that a utility may request an up-front prudence review which would be binding on future commissions with respect to an EWG power purchase. The deadline for such a decision by the state commission is the effective date of the utility's proposed action. This apparent imposition on state authority comes in the context of a

codification of the Pike County doctrine. The practical reality is that any state commission uncomfortable with this new responsibility has the ability, if it so chooses, to forestall a utility purchase from an EWG either by denying the prudence of the purchase, specifying such conditions as FERC rates of a certain level, or simply dragging out the proceeding concluding the proceeding in spite of the deadline which appears to have no default provision.<sup>64</sup>

- The Senate and House bills, while maintaining the longstanding Federal pre-emption of plant cost allocation among the affiliates of registered holding companies, both ensure state prudence review authority with respect to power purchases by affiliates of registered holding companies from affiliated EWGs.<sup>65</sup>
- The Senate and House bills both require the consent of the applicable state for any currently operating wholesale or retail power plant to EWG status.<sup>66</sup>
- The House bill provides that any future integration of operations among electric utilities must gain the prior consent of every state to which service would be provided.<sup>67</sup>
- Finally, both bills provide access by state regulators to the books and records of utilities, utility affiliates and EWGs to the extent required for effective state regulation. This certainly includes such purposes as prudence review and the oversight of inter-affiliate transactions.<sup>68</sup>

An evaluation of the two PUHCA measures must lead to three conclusions with respect to the exercise of state regulation. First, the authority of states to disallow imprudent wholesale costs (and effectively, therefore, imprudent transactions themselves) would be made more clear and definite. Second, in a very practical sense the reach of state regulation has been extended well into the wholesale market. Third, Federal regulatory authority has not been expanded at the expense of state authority.

### Enforcing Service Quality and the "Obligation to Serve"

The core of the "obligation to serve" principle is that in return for local monopoly distribution status, a utility agrees both to serve all comers who are willing to pay and to plan to serve future demand. Enforcement of this obligation with respect to planning to meet overall demand has traditionally been quite general. Theoretically, all that should be necessary to encourage utilities to meet this generalized obligation to serve is to approve rates which are likely to produce an adequate profit. An adequate profit potential will motivate utility managers to take steps to meet expected demand.

There are few, if any, examples of state regulators ordering a utility, against its will, to construct a specific power plant, build a particular transmission line or to make a particular power purchase. There are certainly more examples of state regulatory or other authorities refusing permission to a utility to embark on a project that the utility maintains is worthwhile, or even essential, for adequately discharging its obligation to serve.

In recent years, however, government at the state and Federal level has become more directly involved in resource acquisition decisions by utilities. The two most obvious interventions have been PURPA which required power purchases from QFs at avoided cost and the introduction of various least-cost and integrated resource planning processes in the states. In the case of the state-level planning processes, demand-side options have become increasingly prominent along with supply-side bidding.

The two PUHCA reform proposals in the Congress do not interfere with the right of any state to take steps to enforce the obligation to serve either as it has in the past or in ways it may choose to do so in the future. Importantly, all aspects of utility and state regulatory decisions to create or to do business with EWGs are entirely voluntary. From the Federal level, there would be no obligation for utilities to purchase EWG power or for any regulator to accept any new approach to rate setting. Nor does PUHCA reform reduce the ability of states to require utilities to invest in demand-side measures.

### The Regulation of Utility Capital Structures

Until the recent PUHCA reform debate, the role of utility regulators and of PUHCA with respect to utility capital structures was a topic which received little attention outside regulatory ranks. And even within the ranks of regulators, the subject was an arcane one. Unfortunately, it is also now becoming confused because some opponents of PUHCA reform have addressed the question in ways which have little genuine substance. Unfortunately, arcane matters lend themselves to being twisted beyond all recognition.

Some critics have charged that PUHCA reform would open the door to the creation of large numbers of independent power firms (EWGs) which would be highly leveraged. According to the critics, leveraged EWG capital structures would pose a variety of risks to utility purchasers of their power and to consumers reliant on those purchases.

The most extreme approach to this capital structure argument has been the contention by a few PUHCA reform opponents that the situation which would develop would be akin to that in the savings and loan industry. Although this proposition is absurd on its face, it has managed to gain some currency perhaps because the S&L issue itself is so politically virulent these days. Therefore, it deserves to be addressed with some specificity.

It is important to first consider what regulation of utility capital structure actually is and has been before entering into a debate over the effect PUHCA reform might or might not have on that traditional regulation.

The capital structures of operating utilities are regulated to a limited extent through the exercise of regulatory authority over securities issuance by operating utilities and by utility holding companies. Sections 6 and 7 of PUHCA allocate power of prior approval over securities issuance by registered holding companies and their subsidiaries in order to ensure that operating

utilities will not be burdened by excessive debt obligations incurred outside the jurisdiction of state regulators.

The SEC has operated on a rule of thumb which has regarded 35 percent as the desirable minimum level of equity for utility holding companies, whether registered or exempt. Control over securities issuance by exempt holding companies and their subsidiaries or by operating utilities is left, by default, to the state discretion.

For the most part, utility capital structures are not directly regulated in the way in which, for instance, bank regulators require a minimum ratio of equity capital relative to the overall assets of a bank or S&L.<sup>69</sup> Similarly, insurance regulators insist on a minimum capital and surplus level for an insurer. Banks, S&L's and insurance companies which fail to meet known, pre-determined capital standards are considered impaired and subject to some form of direct supervision by the regulator or other regulatory action.

In reality, the major regulatory encounter with utility capital structures is in the context of rate making. Rates, in part, are calculated to include a component for a return on the equity portion of the capital structure of the operating utility. Similarly, the costs of servicing debt sold by the company are generally recoverable. Normally, state regulators and FERC tend to accept the existing or near-term projection of the capital structure of the utility as a basis for rate making.

Utility regulators also may, in setting rates, attempt to target a future capital structure as a result of the rates being set or may take other steps to encourage the movement by a utility to a more efficient capital structure.

In some cases, state and Federal rate regulatory authorities may choose to impute a capital structure to a utility for rate making purposes. Regulators may assume more or less equity in the attempt to estimate a more efficient and therefore less costly capital structure. Therefore the rates set in the process may be lower for customers than if the actual capital structure were used. For instance, a utility with a very high equity ratio of eighty percent might be accorded only an



imputed equity level of 50 percent because, in the view of regulators, the overall capital structure would be less costly if there were more low cost debt included.

In addition to the question of maintaining rates as low as possible over the long-term through an optimally efficient capital structure, regulators have a responsibility to encourage a utility to maintain the financial flexibility so that the utility can go into the debt market to borrow the substantial sums necessary for construction of a new power plant, in both good markets and bad. There has been a cycle phenomenon in the utility industry in which debt levels rise as money is borrowed and cash is expended on construction of a new plant which is not reflected in rates for the years pending completion. Following the plant's inclusion in rates, the effort is to build the equity level back up in time for the next construction cycle.

It is possible that the pattern of the cycle may change for those utilities which choose to rely on wholesale power purchases to meet new demand. It does not mean, however, that the fundamental financial realities will have changed or that brand new risks are entering the electric industry which consumers have not previously experienced.

The financial community is well aware of the fact that many utilities and regulators are approaching the acquisition of resources in new ways which place greater reliance on wholesale transactions.

For instance, bond rating agencies such as Standard & Poor's and Moody's have traditionally assigned bond ratings to utilities based largely on an evaluation of the capital structure and its effect on the ability to assure serving of the debt. More recently, the bond rating agencies have begun to look at the obligations of utilities under power purchase contracts with other utilities or with PURPA and independent power producers. The credit raters, then, are merely recognizing that one sort of obligation may be partially replacing one with which we have been more familiar.<sup>70</sup>

When Samuel Insull developed the idea of the open-end mortgage bond for utility finance he adjusted electric industry finance in order to meet the demands of the day. He helped reconcile the interest of the financial community in having a reliable flow of coupon payments on asset-secured bonds with the need of utilities to raise enormous amounts of money to build plants and pay the principal back over the many years of useful service from the plant.<sup>71</sup>

As with the open-end mortgage bond, the application of project finance techniques in more recent years should not be regarded with alarm but rather should be understood as a feature of the electric industry financial fabric which has emerged to meet a market demand and need. Many PURPA QF units have been financed with high levels of non-recourse debt where the lenders have relied for security on a variety of risk mitigating factors such as the strength of the power purchase contract with the local utility and the performance guarantees by the equipment, engineering and construction firms.

The PURPA experience has been cited by some critics of PUHCA reform as a harbinger of an electric industry which will become increasingly leveraged and therefore dangerous to the interests of investors and consumers. The further allegation is that EWGs will in some way unfairly rely on the credit of vertically integrated purchasing utilities, to the detriment of the purchaser. Upon closer examination, these contentions are yet another example of apples and oranges comparisons, rather than carefully considered arguments.

First, as noted above, the financial community and investors are fully cognizant of the nature of power project finance and the fact that the overall credit worthiness of both the project financing and of the utility are a function of the total set of liabilities and assets with which to meet those obligations. The financial community is also aware of the role of regulators in overseeing the balance between these liabilities and the ability to meet them. PUHCA reform critics seem to be taking the position that no one will be "minding the store" and that a massive industry will be leveraged up and endangered through the "back door." They further seem to contend that investors will blindly provide funds for over-leveraged, non-credit-worthy companies and projects. This argument ignores the increasing equity requirements now demanded for QF

projects, the "pay for performance" and dispatchability features of many new QF contracts with utilities and other features of maturing QF-utility business relationships.

Second, in sharp contrast to the PURPA obligation to purchase requirements, PUHCA reform measures contain no such obligations. Regulatory obstacles at the state level are actually increased thereby limiting the ability of utilities to make unilateral choices to incur a voluntary obligation to buy EWG power. PUHCA reform critics seem to be suggesting that EWGs will have the privilege of forcing utilities to purchase their power. In fact, the exact opposite is true.

Third, the money invested or lent to finance EWGs will go into precisely the types of generating assets which investors have been accustomed to funding in the electric industry for many decades. Some PUHCA reform critics seem to contend that the invested funds will not go to create long-lasting generating assets available to meet the EWG's contract obligations to its utility customers. Even the financial failure of an EWG firm will not render the power plant inoperative or unavailable. If anything, there will be a greater incentive than ever to operate the plant and sell the power. If, of course, the financial failure results from a lack of demand for the power, then the EWG investors would be the ones with the problem, not the customers of the utility.

Finally, the Senate bill takes the step of requiring state utility commissions to consider whether the capital structure of an EWG, if it contains less than 35 percent equity, will pose any hazard to the financial integrity or the consumers of the utility planning to purchase the EWG-produced power. This mirrors the SEC rule of thumb for registered utility holding companies and their operating companies. While this places added responsibility on the states, it is certainly an expression of confidence in the ability of the states and in their central role as the primary arbiters of utility actions.

### Regulation of Affiliate Transactions and Corporate Structure

The regulation of affiliate transactions is an often misunderstood area of utility regulation. Affiliate transaction regulation is a natural outgrowth of the overall regulatory goal of limiting the opportunity for abuse of monopoly power. The issues of affiliate transactions and corporate structure are closely related to those of diversification which are discussed in the next section of this paper.

As noted earlier in this paper, one of the primary objectives of PUHCA in 1935 was to assist the states in coping with the economic fallout of inter-affiliate transactions which were rampant in the 1920s as the holding company systems grew. PUHCA simplified the corporate structure of holding companies so that state and Federal utility rate regulators would have less difficulty sorting out intercorporate transactions.<sup>72</sup>

The Federal Power Act developed a Federal layer of regulation to oversee wholesale power transactions which take place in interstate commerce and therefore are beyond the reach of an individual state public utility commission.

Given that the bulk of utility activities are at the state regulated level, the states have a significant ability to deal with the question of intercorporate transactions ranging from fuel purchases to computer services. The states can exercise comprehensive oversight of other types of transactions.<sup>73</sup>

States have developed various ways of regulating inter-affiliate transactions over the years, all with attention to limiting the economic consequences of these transactions on consumers. Two major concerns dominate the regulation of affiliate transactions. First, there is often a concern that the captive consumers served by the regulated utility might pay an excessive price for a service provided to a utility by an affiliate. Second, there is a concern that an affiliate might receive a subsidy from the utility designed to enable it to more effectively compete in its market.

Some states have chosen to require utilities under their jurisdiction to seek prior approval of transactions before entering into an affiliate transaction. Even in those states which require prior approval for the transaction to take place, the commissions still retain the authority to disallow recovery from customers of unreasonable or excessive costs related to an affiliate transaction, even though the transaction itself was approved by the commission.

Regardless of the approach taken by a state commission in overseeing affiliate transactions by utilities, accurate and up-to-date information is important to making a fair and reasonable decision on recovery. Therefore, reasonable access to books and records which provide information on the transaction or even on the workings of the unregulated affiliate can prove to be valuable to the regulator.

The access and information issue, however, should not be overplayed. Lack of information, especially if it is the result of a refusal by the utility to provide it, cannot compel state regulators to approve costs for affiliate transactions which they suspect are excess. With respect to affiliate transactions, utilities generally bear an extra burden of proof -- they are obliged to affirmatively demonstrate the reasonableness of the cost rather than relying on a rebuttable presumption of prudence.

Many commissions have concluded that the price paid for a good or service from an affiliate is acceptable if it is comparable to the price that would be charged for the product in the market. In other cases, commissions have determined that the highest acceptable price for a good or service is one that results in a profit level for the affiliate that is equivalent to the profit level the utility itself is permitted by the commission.

Closely associated with state regulatory authority regarding recovery of affiliate transaction costs is the power states can exercise with respect to utility corporate structure. A state legislature may grant authority to its state public utility commission, and many have done so, to control corporate "reconfiguration." Many states require explicit prior approval, for instance, before a utility may act to create a holding company or to establish a subsidiary company under the utility.

There has been criticism that PUHCA reform would exacerbate problems some states have had in controlling the formation by their utilities of exempt holding companies which then engage in affiliate transactions. The mistake should not be made of laying the blame for problems anywhere other than where they belong, which is at the doorstep of state authorities.

PUHCA provides some rules of the game regarding the acceptable corporate structure of registered holding companies and those companies that prefer to avoid becoming registered holding companies. Beyond this general oversight, however, regulation of operational utilities and of exempt holding companies is left to the discretion of the states.

Nothing in the PUHCA reform bills would pre-empt the ability of states to exercise their traditional and well-established authority to oversee affiliate transactions, the recovery of associated costs and the formation of utility corporate relationships. If anything, the PUHCA proposals actually enhance state regulatory authority in several respects. First, both bills explicitly state that the states shall have adequate access to utility and affiliate EWG books and records. Second, the bills ensure that affiliate wholesale transactions are not immune from prudence review by state regulators. Third, the establishment of new integrated utility operations and the spin-off of utility assets to EWG status must receive the prior approval of the state.

#### Regulation of Utility Diversification

PUHCA currently makes it virtually impossible for any electric utility or its holding company to participate in the electric industry beyond the locally franchised, vertically integrated context. Such diversification almost certainly means that a utility would become subject to registration under PUHCA and all that it entails.

It is important to emphasize the substantive distinction between utility diversification within the electric industry as opposed to diversification outside the industry. Under current SEC regulation, PUHCA has placed no significant obstacle in the way of exempt holding companies

or operating utilities diversifying into any non-electric business. Even registered holding companies have diversified outside of the "electric utility company" business (although the process is somewhat more complicated).

The irony, then, is that while most electric utilities can diversify into any non-electric business, given constraints that each state can impose, PUHCA largely shuts off utilities from diversification within the electric industry — the industry that they know best and are most adept at. That leaves only PURPA as an avenue for electric diversification.

PUHCA reform, rather than exposing the industry to more diversification problems, actually will permit utilities to diversify into the one business they know and have done well in.

#### The Overall Relationship of PUHCA Reform to the Fabric of State Utility Regulation

In truth, it is difficult to imagine how the two PUHCA measures could be substantively more accommodating to the expressed desires of state regulators.

The PUHCA reform proposals embody the Pike County doctrine in legislation. They not only scrupulously refrain from interfering with state least-cost planning and reliability authority, they actually ensure that state regulators will have better control over the mix of generation coming from all non-PURPA wholesale sources. They provide ample access to books and records to control affiliate transactions. They provide for prior approval of any transfer of utility assets either to EWG status or to a role in an integrated system or pool. And, by requiring that each state served by common plant have a veto over transfers and pooling, states are given a good combination of autonomy and cooperative responsibility relative to one another.

There have been suggestions that the Pike County doctrine be extended beyond its current limits to include state control over conventional utility affiliate power transactions within registered holding companies. There have also been suggestions that a layer of regional regulation through

multi-state compacts should be established for planning and other purposes.<sup>74</sup> Each of these would represent a major departure from the status quo in terms of the framework of regulation. It should be emphatically appreciated that the two PUHCA measures have taken a conservative or preservationist approach to the effect of PUHCA reform on state regulation. They refrain from creating a new regulatory framework.



### **THE DEBATE OVER TRANSMISSION ACCESS**

The debate over the terms and conditions for access to bulk transmission facilities and service is not new. The issue has, however, grown in intensity since the early-1980s, as the generation sector of the electric industry has become less vertically integrated with the distribution assets which deliver power to consumers.<sup>75</sup>

More recently, transmission access has emerged in the PUHCA reform debate in a curious way. Some opponents of PUHCA reform have claimed that PUHCA reform is dangerous because it will inexorably lead to more pressure for transmission access for non-utility generation, allegedly undermining overall system reliability. They also raise concerns that retail customers would suffer a loss of benefits from some economy energy transactions or that utility assets would be unfairly used by parties other than the owners.

Some proponents of PUHCA reform have expressed similar concerns, while others have taken the position that transmission access is essential for the full flowering of the competitive generating opportunities opened up by PUHCA reform.

The central point, however, is that when considered in the context of the Senate and House PUHCA reform measures, the transmission access provisions in the House bill appear inconsistent in several areas. These inconsistencies are significant in terms of the relationship of PUHCA reform to the maintenance of the traditional regulatory framework, which the PUHCA reform provisions scrupulously attempt to uphold.

While the PUHCA reform provisions themselves are entirely voluntary, the transmission access provisions would involve a mandatory feature. The House measure (Sections 7 and 8) has several mandatory features regarding transmission.

New powers are granted to FERC to order specific actions by regulated entities.

- FERC is obliged under a variety of circumstances to order transmission access, including as a merger condition, the granting of market based rates in utility wholesale sales and protection of the environment.
- FERC is required to make use of traditional rate-of-return regulation under certain circumstances.

While the issues in PUHCA reform are actually well understood, thereby making the question ripe for action, transmission access cannot be considered to be mature. There remain areas of the debate that are not yet fully explicated, such as compensation for unintended loop flow and the status of native load in the evaluation of wholesale access requests. The transmission access issue is a good deal less mature than is PUHCA reform itself.

The PUHCA reform measures do a good job of assuring the traditional role of state utility regulation and draws jurisdictional lines more clearly, while the transmission proposal has Federal pre-emption at its heart. It creates a new Federal regulatory power which has no corollary state authority to provide the balance which characterizes PUHCA reform measures. For instance, the grant of authority to FERC to compel the construction of facilities is not balanced with a state role.

While PUHCA reform is intended to create an atmosphere in which voluntary actions in the market will seek out best solutions, the transmission access measure tends to focus on litigated proceedings before FERC to compel access or the negotiation of access.

While PUHCA reform does not presume that FERC and the states will replace rate-of-return regulation with market-based pricing for competitive generation, it leaves the door open for regulators to apply alternative pricing methods at their discretion. The transmission access measure, however, appears to "lock-in" rate-of-return regulation for transmission, thus ignoring the genuine potential for inadvertent disincentives for increasing the supply of transmission facilities.

While PUHCA reform creates no additional issues for the nexus between anti-trust laws and the electric industry, mandated transmission access necessarily raises the unanswered question as to the extent that such legislation provides some degree of immunity to transmission-owning utilities.

While PUHCA reform implicitly takes account of developments in other policy arenas, including FERC, the courts and state commissions and legislatures, the transmission provisions may be acting too quickly to impose a new regime rather than waiting for these other arenas to help sculpt a long term solution.

The transmission access debate can and should be distinguished from the issues basic to the PUHCA reform debate. In contrast to the more preservationist approach of PUHCA reform, transmission access mandates significantly alter the regulatory and industry landscape through other than voluntary means. Most importantly, they expand Federal regulatory authority at the expense of state regulation.

To the extent that there is a desire to legislate with respect to transmission access in tandem with PUHCA reform, it would be advisable to design a measure which is more consistent with the voluntary and state oriented flavor of the Senate and House bills.

This could be done in several, relatively simple ways which would bring about an accelerated but incremental opening up of the transmissions system rather than creating an entirely new framework for transmission regulation.

First, in the spirit of making the most modest changes in law necessary to accomplish the task, consideration could be given to eliminating the ambiguous requirement in Section 211 of the Federal Power Act that FERC take into account existing competitive relationships when evaluating a transmission request. This would stimulate a greater willingness to arrive at negotiated arrangements.

Second, in the spirit of encouraging volunteerism and creativity through incentives rather than the fear of penalty, FERC could be given explicit authority to experiment with opportunity cost pricing and to accept tariffs negotiated between the parties with only minimal intervention allowed by complaining parties.

Third, in keeping with the tilt toward a reliance on state regulation, states might be permitted to experiment in the pricing of wholesale transmission service which occurs within the boundaries of the individual state.

An incremental approach to transmission access which permits the market to develop, as is clearly the intent in the PUHCA bills, is clearly the best solution at this point in the transmission debate.

**CONCLUSION**

The PUHCA measures now before the House and Senate cannot be considered "deregulation" for the simple reason that there is not a single identifiable utility activity left without a clearly designated and fully empowered regulator. These two bills neither replace nor reformulate electric power regulation. If anything, PUHCA reform involves an effort to gather a variety of relatively new industry activities and ways of doing things into the scope of conventional utility regulation.

The measures realign regulatory boundaries so that responsibilities are clearly allocated between the Federal and state levels. The bills tilt significantly in the direction of favoring state regulation and the ability of the states to exercise discretion in their regulation of the activities which PUHCA reform would permit.

In addition, the two PUHCA reform measures would take an even handed approach to new sources of generation. Utilities, their expertise now often withheld from the market, could become active participants in the potentially important role non-PURPA wholesale power projects can play. PUHCA reform would also provide expanded opportunity for those PURPA and independent power developers who participated in the maturation of a competitive wholesale power industry.

The two measures are incremental and express confidence in conventional state and Federal utility regulation, making concrete the evolutionary model formulated by the Congressional Research Service in its report. This approach contrasts to other formulations, which would reallocate authority between the state and Federal levels at the expense of the states or would deregulate currently regulated operating utility activities.

## ENDNOTES

1. U.S. Congress, Electricity: A New Regulatory Order?, A Report Prepared by the Congressional Research Service (CRS) For the Use of the Committee on Energy and Commerce, June 1991, p. 169. The ten point plan is described in Philip R. O'Connor, Robert G. Basso and Wayne P. Olson, "Competition, Financial Innovation, and Diversification in the Electric Industry," Public Utilities Fortnightly 117 (February 20, 1986): 17-21.
2. William O. Douglas, "Scatteration v. Integration of Public Utility Systems," Public Utilities Fortnightly 22 (August 18, 1938): 255-266. (This is the text of a speech delivered to the Section of Public Utility Law of the American Bar Association at Cleveland, Ohio on July 26, 1938.)
3. William O. Douglas was a Commissioner on the Securities and Exchange Commission from January 1936 to September 1937 and then was Chairman from September 1937 until March 1939. Justice Douglas's term at the SEC ended when he was appointed to the "Brandeis seat" on the U.S. Supreme Court.
4. Department of Energy, National Energy Strategy: Powerful Ideas for America, First Edition 1991/1992 (Washington, D.C.: February 1991), p. 2.
5. A good survey of the issues can be found in Department of Energy, Interim Report: National Energy Strategy -- A Compilation of Public Comments, April 1990 (Washington, D.C.: Department of Energy, April 1990). See also O'Connor, Basso and Olson 1986, pp. 17-21.
6. A somewhat different formulation of these two points can be found in U.S. Congress, Electricity: A New Regulatory Order?, A Report Prepared by the Congressional Research Service (CRS) For the Use of the Committee on Energy and Commerce, June 1991, p. 169.
7. Several efforts have been made over the years to encourage Congress to amend PUHCA. Previous discussions of change to or repeal of PUHCA focused on far different issues than those of today.
8. Don D. Jordan, "The Hidden Threat," Public Utilities Fortnightly 127 (March 15, 1991): 27-29.
9. Bonbright defines a holding company as "a company which is not directly engaged in the business of producing and distributing commodities or services, but which controls such a business through the ownership of stock in operating companies." James C. Bonbright, Public Utilities and the National Power Policies (New York: Columbia University Press, 1940; reprint ed., New York: Da Capo Press, 1972), p. 23.  
  
On the other hand, according to Will Rogers, "A holding company is a thing where you hand an accomplice the goods while the policeman searches you." Donaldson, Lufkin & Jenrette, "Random Gleanings," Portfolio Manager's Weekly, p. 21 citing Brian Stirling, The Best of Will Rogers, Crown.
10. James C. Bonbright and Gardiner C. Means, The Holding Company (New York: McGraw-Hill, 1932; reprint ed., New York: Augustus M. Kelly, 1969), p. 102.
11. Bonbright and Means 1932, p. 97.
12. The growth of electrical demand at the turn of the century is reminiscent of the growth rates we have seen in some modern industries such as the personal computer and the VCR. For instance, Commonwealth Edison Company, the Chicago area component of the Insull system, increased its annual kilowatt-hour sales from about 33 million in 1898 to about 800 million in 1912. Harold L. Platt, The Electric City: Energy and the Growth of the Chicago Area, 1880-1930 (Chicago: University of Chicago Press, 1991), p. 121.

13. *Bonbright and Means 1932, p. 119.*
14. *Martin T. Farris and Roy J. Sampson, Public Utilities: Regulation, Management, and Ownership (Boston: Houghton Mifflin, 1973), p. 139.*
15. *Bonbright and Means 1932, p. 94.*
16. *Section 1(b) of the Act enumerates 5 abuses of the utility holding companies.*

*The FTC's 101-volume report gives a comprehensive review of the utility holding companies. Federal Trade Commission Report to the Senate, "Utility Corporations," S. Doc. No. 92, pt. 72-A, 70th Cong., 1 Sess. 24 (1935), conducted pursuant to S. Res. 83, 70th Cong., 1st Sess. (1928).*

*An additional 6-volume study, prepared under the direction of Walter M.W. Splawn, was prepared by the House Interstate and Foreign Commerce Committee. Report on the Relation of Holding Companies in Power and Gas Affecting Control, H.R. Rep. No. 827, 73d Cong., 2d Sess. (6 Vols. 1933-35), made pursuant to H.R. Res. 59, 72d Cong., 1st Sess. (1932) and H.R.J. Res. 572, 72d Cong., 2d Sess. (1933).*

*The following books and documents provide good summaries of the findings of the abuses of the holding companies.*

*Douglas W. Hawes, Utility Holding Companies (New York: Clark Boardman Co., Inc., 1986), pp. 2-1 to 2-33.*

*Statement of the U.S. Securities and Exchange Commission Concerning Proposals to Amend or Repeal the Public Utility Holding Company Act of 1935 (SEC Statement), June 2, 1982, pp. 5-14.*

*Department of Energy, "Analysis of Options to Amend the Public Utility Holding Company Act of 1935," National Energy Strategy: Technical Annex J, First Edition 1991/1992, pp. 1-7. (hereinafter referred to as NES Technical Annex on Options to Amend PUHCA).*

17. *For example, under the complicated holding company corporate structure used by the Standard Gas and Electric System, it is believed that an equity interest of three million dollars owned by H. M. Byllesby and Company was able to control over one billion dollars in operating company assets. Bonbright and Means 1932, p. 116.*
18. *William O. Douglas referred to "write-ups" as "the sand on which too many holding company structures were erected." Douglas 1938, p. 253. For example, Minnesota Power and Light reportedly had write-ups of 126 percent when it was formed under subholding companies of Electric Bond and Share. Farris and Sampson 1973, p. 152).*
19. *For example, the Associated Gas and Electric System is reported to have had "net income of \$6.4 million for management and construction services alone, representing a 193 percent net profit on its service cost." Charles F. Phillips, Jr., The Regulation of Public Utilities, 2nd ed. (Arlington, Virginia: Public Utilities Reports, Inc., 1988), p. 578 citing FTC, Utility Corporations 1935, pp. 662-663.*
20. *For example, Associated Gas and Electric had eighteen separate classes of bonds and debentures, ten separate classes of preferred and common stock, and a number of other securities in 1931. Bonbright and Means 1932, p. 121.*
21. *SEC Statement 1982, p. 13.*
22. *Bonbright 1940, p. 25.*
23. *Wayne P. Olson, "The Effect on Risk and Return from Utility Diversification," (M.A. thesis, University of North Dakota, 1984), p.25.*
24. *Bonbright 1940, pp. 25-26.*
25. *Phillips 1988, p. 229.*

26. *Commonwealth & Southern, headed by Wendell Willkie from June 1934 until July 1940, had to slash its dividend at one point from 70 cents to a mere 1 cent. Steve Neal, Dark Horse: A Biography of Wendell Willkie (Garden City, New York: Doubleday & Company, 1984), p. 28.*
27. *The DOE's NES Technical Annex on Options to Amend PUHCA report reminds us that operating companies as a group experienced only about a 15 percent decline in revenues from the peak levels of the 1920s to the depths of the Depression in the early 1930s. DOE NES Technical Annex on Options to Amend PUHCA 1991, p. 6.*
28. *This is instructive given the debate in the PUHCA controversy about the role of debt leverage in the independent power industry.*
29. *In the financial markets arena, the SEC was given three new laws to administer, namely, the Securities Act of 1933 (which regulates the initial offering and actual sale of securities in interstate commerce), the Securities and Exchange Act of 1934 (which regulates the trading of securities on secondary markets) and PUHCA. In the energy arena, important New Deal legislation included the Federal Power Act of 1935 (Title II of the Public Utility Act of 1935), the Rural Electrification Act of 1936, the Natural Gas Act of 1938 and PUHCA.*
30. *Section 1(c).*
31. *SEC Statement 1982, p. 44.*
32. *SEC Statement 1982, pp. 30-31.*
33. *Bonbright, an expert on the practices (and excesses) of the holding company systems well before the stock market crash of 1929 regarded investors as the most immediate victims, with the effects on utility customers being unclear. Bonbright 1940, p. 26.*
34. *Wye Energy Group, "The Public Utility Holding Company Act: History and Implications For the 1990s," Clem Whitaker, Jr., Chairman, August 1990, pp. 10 and 14. (A study and analysis prepared by a Wye Energy Group Task Force for the Wye Energy Group.) Contact 1900 L Street, N.W., Suite 300, Washington, D.C., 20046 for further information.*
35. *Douglas 1938, p. 257.*
36. *NES Technical Annex on Options to Amend PUHCA 1991, p. 6 citing SEC Statement 1982, pp. 23-24.*
37. *Neal 1984, pp. 23-180.*
38. *DOE NES Technical Annex on Options to Amend PUHCA 1991, p. 9.*
39. *George S. Yip, "Gateways to Entry," Harvard Business Review, September/October 1982.*
40. *Interestingly, electric utilities or their affiliates can own up to 50 percent of any number of PURPA QFs anywhere in the country without triggering PUHCA. Even the limited number of registered electric holding companies can participate in this market given any needed SEC approvals. Thus, many electric utilities are already involved in diversified electric power activities in which there is only a legal distinction based on meeting PURPA's QF requirements.*
41. *Environmental Action, Inc., et. al. v. FERC, U.S. Court of Appeals (D.C. Circuit), August 2, 1991. (Circuit Judge Douglas Ginsburg wrote the Court's opinion.) See also "EEL Official: Court Ruling Shows Rapidly changing Debate on Industry," Electric Utility Week, August 19, 1991, p. 8.*
42. *Utility Data Institute, Inc., Directory of Selected U.S. Cogeneration, Small Power and Industrial Power Plants, UDI-018-91, Volume 1 (Washington: Utility Data Institute, April 1991), p. 2.*



43. *Actual non-utility installed capacity (summer) totalled 658,728 megawatts in 1989. North American Electric Reliability Council, 1990 Electricity Supply & Demand: For 1990-1992 (Princeton, New Jersey: North American Electric Reliability Council, November 1990), p. 29.*
44. *Utility Data Institute 1991, p. 2.*
45. *Thus, utilities which have ample generating capacity available would incur only additional fuel costs and therefore would be obliged to pay only that price. In other cases, where utilities either were short on generating capacity or projected the need for additional capacity in the near future, the payments would reflect the capital cost of incremental generating units as well as the fuel cost.*
46. *At the time the NOPRs were issued, FERC and Chairman Hesse were roundly criticized from many quarters. It is fair to say, however, that the NOPR was a critical event and that today's debate and much of the activity in the electric industry and regulation have been heavily influenced by the NOPRs and have taken forms prophetically described in the NOPRs. Recently, Chairman Allday's speech to the American Bar Association expressed many of the ideas which can be found (albeit in a less developed form) in the original NOPR.*
47. *The following publication provides a good survey of least-cost planning issues. National Association of Regulatory Utility Commissioners, "Least-Cost Utility Planning Handbook For Public Utility Commissioners," Volume 1 (Washington, D.C.: NARUC, October 1988).*
48. *Dr. Mark N. Cooper, "Testimony on Regulatory Reform in the Electric Utility Industry," Before the Energy and Natural Resources Committee of the U.S. Senate, March 14, 1991.*
49. *The following publication provides a good survey of key DSM-related issues. National Association of Regulatory Utility Commissioners, "The Demand Side: Conceptual and Methodological Issues," Volume 2 of "Utility Planning Handbook For Public Utility Commissioners" (Washington, D.C.: NARUC, October 1988).*
50. *In contrast, the U.S. consumed only 8 percent more energy in 1988 than it did in 1973, resulting in an annualized growth rate of only one-half of one percent per year (or less than one-fifth the level of growth in U.S. GNP during that time period). Interim Report: National Energy Strategy - A Compilation of Public Comments, April 1990 (Washington, D.C.: Department of Energy, April 1990), pp. 10-11.*
51. *Indeed, the more "bullish" forecasts of John Sillin have proven to be the most accurate since the mid-1980s.*
52. *DOE NES Technical Annex on Options to Amend PUHCA 1991, p. 22.*
53. *Utility Data Institute April 1991, pp. 3-5.*
54. *"One of the most unfortunate phrases ever introduced into law or economics was the phrase 'natural monopoly.' Every monopoly is a product of public policy. No present monopoly, public or private, can be traced back through history in a pure form. . . . '[N]atural monopolies' in fact originated in response to a belief that some goal, or goals, of public policy would be advanced by encouraging or permitting a monopoly to be formed, and discouraging or forbidding future competition with this monopoly." James R. Nelson, "The Role of Competition in Regulated Industries," 11 The Antitrust Bulletin 1, 3 (1966) cited in Phillips 1988, p. 67.*
55. *With respect to multi-state holding companies, the most celebrated case has been the allocation by FERC of the capacity (and financial responsibility) of the Grand Gulf nuclear power plant.*
56. *This is known as the "fled rate doctrine." A summary of recent court decisions regarding Federal preemption in the electric utility industry can be found in Peter C. Lesch, Andrea J. Chambers and Christopher T. Boland, "Preemption," Energy Law and Transactions (New York: Matthew Bender, 1990), pp. 144-1 to 144-53.*
57. *Lesch, Chambers and Boland 1990, p. 144-12.*

58. For an example of this view see William D. Steuwer, "Where Theory Meets Reality: the Case Against PUHCA Reform," *The Electricity Journal* 3 (January/February 1990):40-50.
59. The actual extent of "forum shopping" is open to question and may be in the eye of the beholder. For instance, in the cases of Public Service of New Mexico and Commonwealth Edison, two of the better known restructuring efforts by utilities to place generating assets in wholesale subsidiaries, critics wrongly alleged an attempt to escape from state regulation into the arms of FERC. The June 1991 CRS electric industry report even made this mistake in referring to Edison's 1986 proposal to spin-off three new nuclear plants and sell the power back under a five year fixed price contract to the distribution utility. The authors of this paper are thoroughly familiar with both situations.

PNM made extraordinary efforts to develop contractual and state regulatory provisions which would have aborted the entire spin-off of capacity if FERC set rates or terms other than those stipulated to by the New Mexico Public Service Commission and the company. The FERC would have been effectively cut out of the process except as a ratifier of state action. While the 1991 CRS report is correct in citing the importance of New Mexico Public Service Commission staff opposition which centered on transmission issues, the reality is that the PNM proposal fell victim to the intensity of utility politics in the state. PNM was the "biggest game in town" and the proposal never was really given a hearing.

The Commonwealth Edison proposal is unfortunately mischaracterized in the 1991 CRS as a "reorganization that would have done little except circumvent traditional ratemaking for the transferred plants." That is true only in the sense that traditional rate making would have likely produced a higher increase for Edison's customers than the proposed \$660 million plus fuel costs in the plan. The plan would have had an initial duration of only five years at a fixed price stipulated to by the Illinois Commerce Commission. At the end of five years, Illinois regulators would have had the total right to require the commitment of the plants for Edison's retail customers on a right of first refusal or "most favored nation" basis. The best indicator that the disapproval of the proposal did not protect consumers is the recent decision in Illinois for a \$750 million plus fuel costs increase which will likely have a life cycle cost to consumers greater than that of the original proposal.
60. This has usually been new nuclear units whose completion had been delayed by many years resulting in costs substantially in excess of those originally estimated for the project.
61. Dr. Mark N. Cooper, "Testimony on Regulatory Reform in the Electric Utility Industry," Before the Energy and Natural Resources Committee of the U.S. Senate, March 14, 1991.
62. Senate Section 15106(d)(1) & House Section 5(b)(1)
63. Senate Section 15105(d)(2) and House Section 4.
64. Senate Section 15106(d)(1).
65. Senate Section 15106(d)(3) and House Section 4.
66. Senate Section 15101(c) and House Section 3.
67. House Section 4
68. Senate Section 15108 and House Section 4.
69. Caution is advisable in any appeal to PUHCA as representing a guarantee of solvency. The recent bankruptcy filing of Columbia Gas System, a registered holding company, has been accompanied by the bankruptcy of the interstate pipeline company as well. The Columbia Gas distribution subsidiaries have not filed for bankruptcy and, if the experience before PUHCA is any guide, should not be expected to. The Columbia failure is at least as large as the bankruptcy of Public Service New Hampshire an operating utility and exempt from PUHCA. In any of these cases, the effects on consumers will be modest, if any.

70. Deborah Goldsmith, "Utilities' Risks in Purchasing Power," Standard & Poors' Electric & Gas Credit Review, May 11, 1990, pp. 4-7.
71. The innovative features in Insull's open-end bond included: 1) a 45 year term (over twice as long as the then conventional twenty year utility bond); 2) simultaneous maturity rather than serially; 3) an times interest earned coverage test rather than a sinking fund or depreciation reserve; and 4) a limit on total bond issuance of 75 percent of actual plant facilities already in place. McDonald 1962, p. 92.
72. SEC Statement 1982, pp. 41-47.
73. In 1990, Dr. O'Connor served as an expert for AT&T in the last remaining anti-trust suit against that company. In the course of that project, Palmer Bellevue reviewed most of the major telecommunications rate decisions (FCC and nearly every state) during the 20th century in order to assess the treatment of affiliate transactions by regulators between the former Bell System operating telephone companies and Western Electric.
74. "Brown Foresees State Action on Transmission," Electric Power Alert, August 21, 1991, p. T-10.
75. A useful analysis of the evolution of the transmission access debate can be found in Philip R. O'Connor and Gerald M. Keenan, "The Politics and Policy of Access to the Electric Utility Transmission System," Public Utilities Fortnightly, July 7, 1988.

# PALMER BELLEVUE CORPORATION

## PHILIP R. O'CONNOR, PH.D

**Dr. O'Connor is Chairman and President of Chicago-based Palmer Bellevue Corporation.**

**Palmer Bellevue Corporation is a Chicago-based firm specializing in energy resources, electric and gas utilities, telecommunications, and financial services. The firm is involved as both principal and advisor in acquisitions, corporate and financial restructurings, natural gas marketing and acquisition, and in the development and implementation of strategic and public policy options for investor-owned and publicly owned utilities.**

**Prior to forming Palmer Bellevue Corporation in 1985, Dr. O'Connor served as Illinois' chief utility regulator, chairing the Illinois Commerce Commission. Dr. O'Connor also served as Political Director of Governor James R. Thompson's successful third-term election campaign in 1982, and as Director of the Illinois Department of Insurance. He also served as Deputy Director of the Illinois Insurance Department, and as Administrative Assistant to California U.S. Representative George Miller and former Illinois Governor Richard B. Ogilvie.**

**Dr. O'Connor is an Adjunct Fellow of the Hudson Institute and is Chairman of the Council of Advisors of the Institute for Illinois, the research arm of the Illinois Congressional Delegation. He also was selected by the Administrator of the U.S. Environmental Protection Agency to chair the Allowance Tracking and Trading Subcommittee of the Acid Rain Advisory Committee.**

**A native of California, O'Connor attended the University of San Francisco, the Loyola University of Chicago-Rome Campus of Liberal Arts in Italy, graduated *Magna cum laude* from Loyola University of Chicago, and received his Masters and Doctoral degrees in Political Science from Northwestern University.**

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**WAYNE P. OLSON, CFA**

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**Palmer Bellevue Corporation is a Chicago-based firm that provides consulting and financial advisory services in energy resources, electric and gas utilities, telecommunications and financial services. The firm is involved as both principal and advisor in acquisitions, corporate and financial restructuring, natural gas marketing and acquisition and in the development and implementation of strategic options for both investor-owned and publicly owned utilities.**

**Prior to joining Palmer Bellevue, Mr. Olson was an International Banking Officer at Westpac Banking Corporation, an Australian bank. At Westpac, Mr. Olson was part of a Special Industries team that specialized in providing financing to electric, telecommunications, cable TV and cogeneration entities. Before joining Westpac, Mr. Olson was a Financial Analyst in the Economics and Rates department of the Illinois Commerce Commission. He has testified on the cost of capital and other financial issues before the Illinois Commission.**

**Mr. Olson received an M.A. in Economics and a B.S. in business administration with majors in economics and accounting from the University of North Dakota. Mr. Olson's M.A. thesis was entitled "The Effect on Risk and Return from Utility Diversification." Mr. Olson is a Chartered Financial Analyst as well as a Certified Public Accountant.**

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**GERALD M. KEENAN**

Gerald M. Keenan is Senior Vice President of Chicago-based Palmer Bellevue Corporation.

Palmer Bellevue provides consulting, financial and demand-side management services to the utility, natural gas, telecommunications, independent power and related industries.

Mr. Keenan and his colleagues have been active participants in the legislative and regulatory debates regarding the enactment and implementation of the Clean Air Act Amendments of 1990. Mr. Keenan assisted one of the nation's largest utilities in developing and implementing its successful legislative strategy regarding the Acid Rain Title. He is a frequent speaker regarding the impact on utilities of the Acid Rain Title and is the author of a chapter regarding the effect of that legislation on utility operations in The New Clean Air Act: Compliance and Opportunity, published by Public Utility Reports.

Mr. Keenan also serves as industry and regulatory advisor to natural gas pipelines, storage companies, producers and marketers.

Prior to joining Palmer Bellevue in January 1986, Mr. Keenan served as General Manager of the Illinois Commerce Commission, which regulates public utilities and transportation companies in that State. Mr. Keenan also served as the ICC's Director of Intergovernmental and Public Affairs, representing the State of Illinois in Washington, D.C. on utility and other energy related issues before Congress and Federal agencies. Previously, he served as Manager of the Commission's Consumer Affairs Divisions, Research Coordinator for the National Training and Information Center, and was engaged in the retail petroleum marketing business.

Mr. Keenan holds a B.A. from Northwestern University in Evanston, Illinois.

## National Independent Energy Producers

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SUMMARY TESTIMONY OF PAUL J. ELSTON, CHAIRMAN & CEO, LONG LAKE ENERGY CORPORATION AND VICE-PRESIDENT, NATIONAL INDEPENDENT ENERGY PRODUCERS TO THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

September 17, 1991

The National Independent Energy Producers (NIEP), an association of companies that generate electricity and sell to utilities in a competitive market, expresses its strong support for Title XV of S. 1220, the National Energy Security Act of 1991. Title XV would reform the Public Utility Holding Company Act of 1935 (PUHCA) and enhance competition in wholesale electric generation markets.

Title XV of S. 1220 will foster competition and produce economic efficiencies, fuel savings, and environmental protection -- all at the lowest possible cost to consumers.

My testimony on S. 1220 will include a report on the status of competition; address in detail improvements to PUHCA legislation; discuss and make recommendations regarding the implications of debt leveraging on IPPs and utilities; and review the impact of environmental concerns on legislation.

### II. STATUS OF COMPETITIVE POWER MARKET

The nation's consumers have much to gain from increased participation of independent generators in competitive electric power markets. During the past decade QFs and non-QF Independent Power Producers (IPPs) have grown to over 37,000 megawatts (MW) of electric generating capacity, or about five percent of the nation's capacity.

Since 1984, utilities and public utility commissions in 36 states have adopted or are developing competitive bidding to procure generation capacity. As of May 1991, 72 requests for proposals have been issued, resulting in developers bidding nearly 159,000 MW of capacity. On average, eight MW have been bid for each one requested.

### III. CONSUMER PROTECTION - SELF-DEALING AND CROSS SUBSIDIES

While we applaud the efforts of Senators Johnston and Wallop to strengthen consumer protection, NIEP believes that

additional consumer protections are warranted in order to ensure free and fair competition.

#### Prevention of Undue Influence Through an Affiliate Relationship

NIEP recommends that state commissions regulating utilities with EWG affiliates be specifically authorized to monitor cross-subsidies and that an EWG upon application to FERC for approval of wholesale rates, must show that the state commission with jurisdiction over any utility investor in the EWG has certified to the FERC that it has in place a system or process for monitoring and remedying cross-subsidies on a generic basis. FERC would be authorized to deny pricing approval to an EWG which had not made such a showing.

#### Access to Books and Records

NIEP agrees that access to books and records is necessary to detect cross-subsidies when there is a possibility of misuse of assets of utility ratepayers. We also do not believe that such access is appropriate for EWGs that are not affiliated with a utility and where, therefore, no issue of possible cross-subsidies arises. State commissions, moreover, should not be able to examine the books and records of affiliated EWGs for the purpose of regulating their profits.

#### IV. AFFILIATE SALES TO UTILITY PARENTS

NIEP strongly supports the position that the burden of persuasion should be on the utility proposing to buy from its affiliate and that such purchases should not go forward unless first approved by the state regulatory authority. NIEP, however, opposes a statutory prohibition on sales by a utility affiliate to its parent.

We propose, instead, that Congress codify the current federal policy, as expressed in some 20 market-based pricing cases to date, of having FERC give close scrutiny to market power issues any time a sale by an EWG to its utility parent is involved.

#### V. TRANSMISSION

NIEP believes that the current protection against potential abuse of transmission ownership in S 1220 is too narrow, as FERC remains powerless with respect to ordering transmission. Consequently, we support an amendment to S 1220 which we understand will be offered by Senators Bradley and Domenici. This amendment would give the FERC, upon petition by a wholesale



generator, the authority to order transmission access when it finds that by doing so it will promote competition in electric power markets or prevent abuse of market power by transmission owners.

#### **VI. FINANCIAL LEVERAGING**

NIEP opposes the provision in Section 15107 that requires state commissions to consider whether equity levels less than 35% may impair the contract reliability of the EWG or give it an unfair competitive advantage over a utility. Contrary to popular myth, three strong arguments suggest that greater regulatory supervision is not necessary:

- 1) There is no evidence to suggest that higher debt levels of IPPs decrease their cost of capital, granting them a competitive advantage over traditional utilities. For a variety of reasons, costs of capital for IPPs and utilities have proven to be approximately the same.
- 2) Purchasing power does not have an adverse impact on the capital structure of a utility or its credit rating. In fact, experience has shown that buying instead of building may improve a utility's financial position and credit rating.
- 3) The greater leverage of IPPs has no impact on project reliability. By all accounts, the record of non-utility generators is excellent, both under normal operating conditions and in emergency situations. Consistent with other studies, a recent survey of 172 projects selected through competitive bidding since 1984 shows that the vast majority of projects (85 percent) are in development, under construction or on-line.

#### **VII. STATE AND FEDERAL JURISDICTION**

NIEP strongly opposes the stranded investment provision in Section 15103 as an unjustified interference in appropriate state regulation. The provision gives utilities a club to use against their state commission and a license to meddle in FERC approval of EWG contracts.

NIEP supports affirming state authority by codifying the so-called Pike County doctrine and pre-approving contracts embodied in this provision but recommends that disincentives for registered holding companies to make purchases from EWGs be removed by requiring that FERC alone approve such contracts.

NIEP also proposes that the FERC be authorized to delegate to the state commissions its authority to approve market

pricing for EWGs that are not affiliated with the purchasing utility, if the FERC, after appropriate notice and comment, finds that no negative impact on competition will result from this delegation.

#### VIII. ENVIRONMENTAL IMPACTS

PUHCA reform advances environmental protection by giving utilities a greater spectrum of choice in obtaining the new electric capacity most compatible with state and federal environmental standards. The competition that develops as a result encourages innovation and efficiency in complying with environmental standards and gives state regulators a market-tested benchmark for evaluating the pollution mitigation proposals of traditional utilities.

#### CONCLUSION

NIEP believes that PUHCA reform structured to prevent abuse of market power and promote free and fair competition offers maximum flexibility to utilities to select the kind of power which best meets their needs.

Reform of PUHCA will also secure greater energy efficiency, billions of dollars in savings in coming decades, and a viable source of energy for the future.

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TESTIMONY OF PAUL J. ELSTON  
CHAIRMAN & CEO  
LONG LAKE ENERGY CORPORATION  
VICE-PRESIDENT  
NATIONAL INDEPENDENT ENERGY PRODUCERS  
ON BEHALF OF NATIONAL INDEPENDENT ENERGY PRODUCERS  
SUBMITTED FOR THE RECORD

before the

UNITED STATES SENATE  
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS  
SUBCOMMITTEE ON SECURITIES  
Washington, D.C.

Hearings On:  
Title XV of S. 1220  
The National Energy Security Act of 1991

September 17, 1991

## I. INTRODUCTION

It is my pleasure to accept your invitation to testify on behalf of the National Independent Energy Producers ("NIEP") before the Subcommittee on Securities regarding Title XV of the National Energy Security Act of 1991 (S. 1220). I am Chairman and CEO of Long Lake Energy Corporation, a private developer of independent power and Vice-Chairman of NIEP. On behalf of NIEP, I am pleased to submit the following statement for the record.

NIEP is an association of companies that generate electricity for sale to utilities and develop cogeneration projects for a variety of users. NIEP membership is comprised of both publicly traded and privately held corporations that represent the entire spectrum of fossil fuel-fired and renewable technologies, including hydro, pumped

storage, biomass, geothermal, wind, wood and waste-to-energy plants, as well as oil, gas and coal-fired cogeneration and independent generation facilities. We do not build rate-based powerplants. Our plants use the latest and cleanest technologies.

NIEP is committed to increasing competition in electric power generation markets to improve the efficiency of those markets. Independent generation has grown out of the entrepreneurial and competitive climate fostered by the Public Utility Regulatory Policies Act of 1978 (PURPA). Since this 1978 legislation made the competitive power industry a possibility, independent electric producers have grown to more than 37,000 megawatts of capacity -- equivalent to over 30 large nuclear power plants. In addition, this new industry has supplied about 20 percent of all new electric capacity since 1978 and has brought on-line 50 percent of new capacity since 1989.

Independent generators in competitive power markets therefore already play a vital role in meeting the demand for new electric generating capacity. NIEP believes that competition in electric generation markets is the best system for achieving energy, economic and environmental efficiencies in the production of electricity. Reaching these goals in the electricity sector is essential for the nation's competitiveness in global markets.

In light of these goals, NIEP advocates amendments to the Public Utility Holding Company Act of 1935 (PUHCA) to remove institutional and regulatory barriers to market entry by independent generators of electricity (called "exempt wholesale generators -- EWGs" in the legislation).

We strongly support the efforts of Senators Johnston, Wallop and their committee colleagues to remove statutory impediments to competition in electric power markets. Currently, PUHCA blocks entry by independent generators notwithstanding their lack of market power, when it was intended to do something else -- end the monopolistic abuses of ratepayers and shareholders associated with dispersed utility holding companies in the 1920s and 1930s.

NIEP supports the provisions in Title XV which improve the Public Utility Holding Company Act by:

- creating a class of exempt wholesale generators (EWGs), freed from regulation under PUHCA. This would permit independents, and subsidiaries of utilities and utility holding companies, to develop EWGs to compete for the right to supply new capacity when utilities decide they need capacity. This will offer utilities additional, efficient generation options;
- permitting owners of qualifying facilities to own EWGs without jeopardizing their QF ownership;
- permitting exempt utility holding companies to own EWGs without jeopardizing their current exemption;
- permitting registered utility holding companies to invest in EWGs without triggering the "integration" requirements of PUHCA (all other regulatory requirements would remain intact); and,
- requiring regulatory approval to convert a rate-based facility to EWG status.

Changes in PUHCA are essential to promote competition in wholesale electric generation markets for the benefit of the nation's consumers because they will give utilities additional supply options from which to choose in meeting ratepayer needs.

With these thoughts in mind, in this statement I will:

- report on the status of competition;
- address in detail improvements to PUHCA legislation, including:
  - additional consumer protections against self-dealing, cross-subsidies and other anti-competitive impacts;

- recommendations regarding regulation of affiliate sales;
  - greater protection against potential abuse of ownership or control of transmission facilities;
  - clarification of state authority over EWGs, including codification of the Pike County decision, removal of disincentives for registered holding companies to make purchases from EWGs, and delegation by FERC of authority to approve market pricing for nonaffiliated EWGs to state commissions or multi-state boards;
  - relief for true independents from regulations designed for franchised monopolies or their affiliates.
- discuss and make recommendations regarding the implications of debt leveraging on IPPs and utilities; and
  - review the impact of environmental concerns on legislation.

As you review this landmark legislation, we respectfully request that you consider these changes that we believe will enhance consumer protection and competition.

## II. STATUS OF COMPETITIVE POWER MARKET

The nation's consumers have much to gain from increased participation of independent generators in competitive electric power markets. First, a decade of experience with the Qualifying Facilities (QF) under PURPA has shown that non-utility generation can compete effectively on a cost basis with utility facilities to provide efficient and reliable generation for the nation.

The success of the QF program, and non-utility generation in general, in providing new electric generating capacity and in bringing competition to power markets, has

far exceeded expectations. During the past decade, QFs and non-QF Independent Power Producers (IPPs) have grown to over 37,000 megawatts (MW) of electric generating capacity, or about five percent of the nation's capacity.

Also, competitive processes to supply future capacity needs are taking hold throughout the nation. Since 1984, utilities and public utility commissions in 36 states have adopted or are developing competitive bidding to procure generation capacity. As of August 1991, 72 requests for proposals have been issued, resulting in developers bidding nearly 159,000 MW of capacity. On average, eight MW have been bid for each one requested. In addition, independents have offered utilities seeking capacity other competitive options outside formal bidding. Utilities and independents use competitive negotiation and arms-length negotiation to solicit and propose projects outside bidding or where bidding does not yet exist. Developers have offered diverse fuels and technologies in their efforts to gain a competitive advantage.

As we look at the data provided by examining competitive procurement systems, there is no question that the process has led to lower costs for electricity. By August of 1991, as a result of competitive bid solicitations, utilities awarded bids to nearly 13,000 megawatts of capacity. In each of these winning bids, the utility's decision to buy capacity rather than build resulted from its own evaluation that wholesale power purchase would be cheaper. In the relatively short time since competitive bidding began, over 1750 MW procured through bidding have completed development and have begun delivering power.

#### IPPs Are Good for Competition

IPPs are important for competition for a number of reasons. First QFs must either "cogenerate" steam and electricity or use a renewable technology. The availability of "steam hosts" for cogeneration will not necessarily correspond to areas which need electricity, and, while there certainly is untapped renewable potential, the availability of renewables will not necessarily correspond to areas which need electricity. By contrast, IPPs can locate near load centers, fuel supplies or transmission interconnections. IPPs can also be sized to meet the needs of the purchasing

utilities. On the other hand, to meet PURPA's requirements, QFs are restricted by the size of their steam loads. More suppliers can enter the market as well, not just companies with access to steam hosts.

IPPs can also be more responsive to utilities' demands for plants which are "dispatchable." A dispatchable contract permits a utility to schedule operation of non-utility generators to meet a utility's demands. Cogenerators, to maintain their QF status, operate according to the needs of their steam host and, many times, must produce electricity around the clock. Currently, many utilities seek to buy power from plants they can dispatch according to their "peaking" needs. Peaking plants operate only during spikes in the demand for electricity and usually operate no more than a few hours a day or a month. These plants must generally be available around the clock and start up quickly.

IPPs can create new and viable options for utilities and states. PUHCA reform will permit new suppliers to enter the market and increase the choices utilities and states have to meet growing electricity demand. Increased competition gives regulators a benchmark for assessing the performance of their utilities versus other real options.

Modification of PUHCA, therefore, is needed to assure that wholesale generation facilities, in addition to QFs and ratebased plants, will be able to meet the demand for electric generating capacity. In addition, changes that exempt independent generators which lack market power from PUHCA will allow developers to make truly economic and optimal choices in corporate structure, siting, size and technology.

### III. CONSUMER PROTECTION - SELF-DEALING AND CROSS SUBSIDIES

While we applaud the efforts of Senators Johnston and Wallop to strengthen consumer protection, NIEP believes that additional consumer protections are warranted in order to ensure free and fair competition. The current regulatory structure governing wholesale markets is somewhat undefined. FERC has gaps in its authority and the role of states is unclear. An effective regulatory system to protect the



consumer and promote free and fair competition must have clear authorities, sensible rules and strong enforcement mechanisms.

By free and fair competition, we mean any competitive process (whether formal competitive bidding, arms-length negotiation or other competitive process) consistent with resource or least-cost planning goals, in which there is no abuse of market power by the EWG, its affiliates, or by the purchasing utility, including no improper self-dealing between the EWG and the purchasing utility or utilities, no cross-subsidization of the EWG with ratepayer assets by an affiliated utility or utilities, no improper reciprocal dealing between an EWG's affiliated utility and other utilities, and no unfair or discriminatory use of control of transmission facilities by the EWG or any affiliated utility.

#### Prevention of Undue Influence Through an Affiliate Relationship

S.1220 addresses this issue in Section 15105. Provisions in this section would prevent FERC from approving wholesale rates for EWGs where the EWG has received "undue advantage" from an affiliation with a purchasing utility.

NIEP supports this provision but does not feel it goes far enough. By focusing on transactions between an affiliate and a purchasing utility, it addresses self-dealing but ignores the potential for cross-subsidy abuses when an affiliate is selling to another unrelated utility.

NIEP recommends that state commissions regulating utilities with EWG affiliates be specifically authorized to monitor cross-subsidies and that an EWG, upon application to FERC for approval of wholesale rates, must show that the state commission with jurisdiction over any utility investor in the EWG has certified to the FERC that it has in place a system or process for monitoring and remedying cross-subsidies on a generic basis. FERC would be authorized to deny pricing approval to an EWG which had not made such a showing.

#### Access to Books and Records

To enable state commissions to monitor for cross-subsidies with respect to EWG sales both inside and outside their territory, S. 1220 provides regulators access to the books and records of EWGs. The Committee Report notes that the principal purpose of this provision is to prevent cross-subsidies using ratepayer assets in favor of an affiliated EWG. NIEP agrees that such access to books and records is necessary to detect cross-subsidies when there is a possibility of misuse of assets of captive ratepayers. State commissions however should not be able to examine the books and records of affiliated EWGs for the purpose of regulating their profits. Such regulation would frustrate the purpose of competitive contracting and ultimately deprive ratepayers of its benefits.

We do not believe, however, that such access is appropriate for EWGs that are not affiliated with a utility and where, therefore, no issue of possible cross-subsidies arises. For the same reasons mentioned above there is also no reason to examine books and records for the purpose of regulation of profit. Furthermore the safeguards of financial soundness built into the competitive procurement process and the resulting power purchase agreements negotiated at arms' length between utilities and EWGs make federal law requiring access redundant for reliability purposes.

#### IV. AFFILIATE SALES TO UTILITY PARENTS

NIEP strongly supports the position that the burden of persuasion should be on the utility proposing to buy from its affiliate and that such purchases should not go forward unless first approved by the state regulatory authority. NIEP, however, opposes a statutory prohibition on sales by a utility affiliate to its parent. We do not feel federal preemption of state discretion in this area is warranted. Such a prohibition by Congress would interfere with legitimate state authority. Many state public service commissions have long established policies for protecting against self-dealing between a utility and its affiliates. Some states, like Virginia, have adopted affiliate laws that forbid any affiliate transactions. Others, like

Massachusetts, permit affiliate sales subject to careful scrutiny by state regulators.

We propose, instead, that Congress codify the current federal policy, as expressed in some 20 market-based pricing cases to date, of having FERC give close scrutiny to market power issues any time a sale by an EWG to its utility parent is involved. A prohibition of any sale by an EWG to an affiliated utility would prohibit sales even on a cost-of-service basis.

Banning utility purchases from affiliates will not protect competition if the utility then gives an unfair preference to its own cost-of-service proposal over competing third party alternatives. Indeed, "self-dealing" practices such as faulty cost comparison of a "build" proposal vis-a-vis a competing EWG may be more difficult for regulators to detect in such a case than they would be with a separate affiliate.

Whether the utility buys from an affiliate or chooses to build on a cost-of-service basis, the best protection against harm to ratepayers from self-dealing is subjecting all new capacity options to competition under the same terms and conditions. NIEP is working with state commissions to encourage adoption of rules of competition that will have this result.

#### V. TRANSMISSION

Electricity generators use transmission facilities as the highway to market least-cost power. Access to transmission is critical to the continued success of independent power. Martin Allday, Chairman of the Federal Energy Regulatory Commission, underscored the significance of access to transmission in stating recently:

Transmission has been a key concern in our market pricing cases. We can have lots of people willing and able to build new and efficient generating facilities, but it doesn't do much good if those who control transmission lines won't let the power go where it's most valued.<sup>1</sup>

Denial of access by owners of transmission lines prevents electricity producers from selecting the optimum locations and fuels for their plants, inhibits the development of site-bound renewable resources, and discourages new entrants into competitive markets.

The Report to S.1220 notes that both FERC and DOE have testified that the Federal Power Act prohibits an EWG that controls transmission facilities from using that control to exercise market power over a purchaser of its power.

NIEP believes that this protection against potential abuse of transmission ownership is too narrow, as FERC is rendered powerless with respect to ordering transmission. Consequently, we support an amendment to S.1220 which we understand will be offered by Senators Bradley and Domenici. This amendment would give the FERC, upon petition by a wholesale generator, the authority to order transmission access when it finds that by doing so it will promote competition in electric power markets or prevent abuse of market power by transmission owners.

Specifically, the Bradley/Domenici amendment would amend Sec. 211(c)(1) of the Federal Power Act to remove the requirement that FERC "preserve existing competitive relationships" in ordering transmission access. Increased competition, by definition, alters the competitive status quo in any market. It should be the goal of a transmission order, not a reason for denying it.

#### VI. FINANCIAL LEVERAGING

S.1220's provisions with respect to financial leveraging (Sec. 15107) require state commissions to consider, on a general basis, the potential impact of a wholesale power supplier's capital structure on the purchasing utility's cost of capital and on the supplier's financial soundness. The provision also requires state

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1/ Remarks of Martin Allday before the American Bar Association, Atlanta GA, August 13, 1991.

commissions to pre-approve long-term wholesale power contracts, and in doing so, to conduct a "reliability" review of the fuel provisions of the contract.

Specifically, the provision requires state commissions to consider whether equity levels less than 35% may impair the contract reliability of the EWG or give it an unfair competitive advantage over a utility. NIEP strongly objects to legislation of a fixed equity percentage number which will interfere with market based financing of independent projects.

The Committee Report notes correctly that "there is a significant difference of opinion" concerning the merits of this regulatory issue. Three arguments have been made to support why greater regulatory supervision -- similar to provisions in Section 15107 -- is necessary:

- 1) Higher debt levels of IPPs decrease their cost of capital, granting them a competitive advantage over traditional utilities;
- 2) Purchasing power imposes fixed cost obligations on a utility which are viewed by credit rating agencies as long term debt. This newly acquired debt, as the argument goes, destabilizes the utility's capital structure, increases its cost of capital, and jeopardizes its credit rating;
- 3) IPPs' unsound capital structures make purchased power an unreliable source of energy.

The flaws in each of these arguments are discussed below.

#### The Putative Competitive Advantage

There are a variety of reasons why the more highly leveraged IPPs do not enjoy a competitive advantage over utilities. First, in financing power projects where the leverage is greater than 75 to 80 percent, the borrower generally pays a premium on the amount borrowed in excess of a "conventional" leverage amount. Thus, the alleged financial advantages of higher leverage can be, in many

cases, substantially nullified by the premium imposed on such leveraging. Moreover, which party has the cost of capital advantage will vary according to the particular project -- independents simply offer utilities alternatives against which to judge the relative economics of their resource options.

Second, the cost of equity capital is greater for independents since they must raise their equity capital before construction and commercial operation. Independents must raise capital in a market fully aware of the risks inherent in investing in the facility. Since independents do not enjoy the security of a utility's franchised service territory, their costs of capital are greater. Therefore, the only way independents can be competitive is by lowering the required amount of equity in the project.

Third, although IPP project financing typically starts with approximately 80% debt, project cash flow is pledged to retire that debt within 15 to 20 years of a 30-year project life. Thus, not only is the term of debt shorter (utilities generally borrow for 30 years more), but so is the average percentage of debt over project life (24% for IPPs versus 57% for investor-owned electric utilities, assuming the conventional 15-year loan).

Fourth, utilities provide other services to their ratepayers that do not add revenues to their bottom line. This is why some state commissions require utilities to maintain greater levels of equity namely, to provide for cash outlays for services unrelated to power production and sales. Conversely, IPPs almost exclusively base cash flows on power sold and performance.

In summing up the leveraging issue, Goldman-Sachs noted in a letter to the Senate Energy Committee, dated April 18, 1991:

A MOG's ability to achieve a cost of capital advantage is dependent on the requirements of arranging non-recourse project financing on attractive terms and conditions. Credit enhancement mechanisms and shorter debt maturities increase financing costs and serve to erode any advantage created by higher leverage. In addition,

unpredictable access to the world's capital markets further disadvantages NUGs and increases their implicit cost of capital."

In essence, third party power suppliers do not enjoy a cost-of-capital advantage in procuring in arranging financing for their projects.

#### Impact on Credit Ratings

Some have also argued that purchasing power imposes fixed costs which raise a utility's cost of capital and threaten its credit standing. This assertion derives from a misunderstanding of the implications of financing and contracting for third-party generation on the capital structure of the purchasing utility. Indeed, purchasing power rather than utility construction may improve a utility's financial position and credit rating.<sup>2/</sup>

The central inaccuracy of the credit rating argument is equating a power purchase contract with debt. For this argument to be true, power purchase contracts would have to be "take-or-pay" contracts, or agreements in which utilities are obligated to make fixed capacity payments to a non-utility generator (NUG) regardless of whether the power is available.<sup>3/</sup> In reality, IPPs and NUGs offer -- and utilities sign -- "take-and-pay" or "performance" contracts in which the utility must pay only if the power is produced and available in accordance with the contract.<sup>4/</sup> If the NUG

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<sup>2/</sup> Naill, Roger F. and Sharp, Barry, "The Effects of Independent Power on Utilities' Credit Rating," page w (unpublished manuscript) [hereinafter "Naill"].

<sup>3/</sup> Standard and Poors' "Utilities' Risks in Purchasing Power," Credit Comment, March 26, 1990, page 3 [hereinafter "S&P Credit Comment"].

<sup>4/</sup> Id.

is not producing according to contract terms, the utility is not required to make capacity payments.

Thus, the essential difference between "take-or-pay" and "take-and-pay" contracts is the conditional obligation imposed upon the utility. The conditional nature determines whether an obligation should be considered debt. The significance of this distinction is recognized by the credit rating agencies. Standard and Poor's has stated unequivocally that the performance condition differentiating "take-or-pay" and "take-and-pay" contracts is "the essential element determining whether the off-balance-sheet liability is firm enough to be considered a debt equivalent."<sup>5/</sup>

Even more reassuring is the experience of utilities that purchase power. Neither Standard and Poor's nor Moody's -- according to their established credit criteria -- has lowered the credit rating of any utility as a result of taking on third party capacity. This is not the case, however, with utilities who build rather than buy. PEPCO was the most recent utility to suffer a downgraded credit rating as a result of an ambitious construction program.<sup>6/</sup>

#### Reliability

Some utilities have disputed the gains from competition in power markets. In the last decade, independents have proven their ability to both construct and operate power plants reliably. By all accounts, the record of non-utility generators is excellent, both under normal operating conditions and in emergency situations.

Selling power under a contract price to utilities creates strong incentives for reliable operation. Wholesale generators who are paid only for power actually delivered have a strong financial interest in the reliability of their

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5/ S&P Credit Comment at page 4.

6/ Washington Post, "PEPCO Construction Program Leads to Cut in Debt Rating," July 26, 1991, page G-1.



facilities, stronger in many cases than utilities that can pass the costs of their mistakes on to ratepayers if their facilities do not operate properly.

A recent survey of 172 projects selected through competitive bidding since 1984 shows that the vast majority of projects (85 percent) are in development, under construction or on-line. Less than 15 percent of those projects have been canceled, most of them very early in the process, and with little or no impact on utilities' supply plans. In addition, utilities can and do factor failure rate for projects selected through competitive bidding into their resource plans.

The nature of the project finance process provides a powerful discipline to ensure reliability. For example, each project generally goes through three independent engineering evaluations: the developer, the construction-lender, and the suppliers of long-term financing. All have experts who intensively review every aspect of the design and construction plan of the project because they only get paid if the facility operates as specified.

Nevertheless, some utilities argue that you cannot count on independent energy projects because independents, unlike vertically integrated utilities (which control generation, transmission and distribution), do not have an "obligation to serve." As William Berry, Chairman of Virginia Power, noted in a recent speech, however:

The independent capacity already in service has had excellent reliability, with availabilities in excess of 90 percent. The capacity that we have bought competitively is essentially dispatchable and the larger units are under automatic generation control just like our own units. Our ability to control our generating system is as strong as ever.<sup>1/</sup>

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<sup>1/</sup> Remarks at Congressional Staff Briefing, February 1991.

Although independents may not have a statutory obligation to serve, they clearly have the incentive and a contractual obligation to serve, both in their power sales agreement with the utility and in multiple agreements with lenders. Independents are subject to obligations to deliver power according to specific operating standards. They suffer severe financial penalties if they fail to satisfy these commitments. They also rely on the same performance guarantees from equipment suppliers, such as General Electric and Westinghouse, that utilities rely on in building their plants. In the rare event that an independent project fails, performance obligations flow to the lender whose only recourse to recover his investment is to operate the facility and deliver power in accordance with the power sales agreement.

In sum, the financial leveraging of IPPs does not compromise the quality and reliability of third party power, and NIEP recommends that the restrictive provisions with respect to these areas be removed from S. 1220.

#### **VII. STATE AND FEDERAL JURISDICTION**

One of the concerns of state commissions regarding PUHCA reform is that reform will lead to a reduction in state control over generating facilities located in its borders. NIEP supports efforts to reduce jurisdictional conflicts between the states and FERC and makes recommendations in the areas below.

##### **Stranded Investment (Sec. 15103)**

This provision is designed to insure that EWGs compete to serve incremental electric demand without interfering with recovery of a purchasing utility's existing capital investment in generation. This provision would require FERC to disapprove wholesale purchases which have the effect, by virtue of substitution of the EWG's electricity energy for the purchaser's own generation, of leading public service commissions to disallow utility investment in cost-of-service facilities either under construction as of the date of enactment, or already built. The provision responds to fears by utilities that the availability of cheaper power from EWGs will increase the probability of nonrecovery of a utility's capital investment.

NIEP strongly opposes this provision as an unjustified interference in appropriate state regulation. NARUC and the consumer groups also strongly oppose this provision. It will give utilities a club to use against their state commission and a license to meddle in FERC approval of EWG contracts.

Clarifying State Authority (Sec. 15106)

This provision affirms the authority of state commissions to prohibit the purchase of wholesale power by a jurisdictional utility, to allow or disallow the inclusion of costs of the purchase in retail rates, and to impose any other condition the state finds necessary to protect consumers, including requirements on the amount of equity investment which must be maintained in the capital structure of the EWG.

An exception to this rule applies to transactions between affiliates of registered holding companies or between several such affiliates and "a person who is not an affiliate," so long as the seller is not an EWG. In the case of a purchase from an EWG by a registered holding company, the purchaser must seek consent from every state commission with jurisdiction over any affiliate of the holding company. This requirement will create a significant disincentive for purchase from EWGs.

Section 15106 would also require state commissions, upon request by a purchasing utility, to pre-approve contracts with EWGs. Once a commission had approved the contract, it could not later reconsider the prudence of the purchase in a subsequent rate proceeding.

NIEP supports affirming state authority by codifying the so-called Pike County doctrine and pre-approving contracts embodied in this provision but recommends that disincentives for registered holding companies to make purchases from EWGs be removed by requiring that FERC alone approve such contracts.

Delegated State Authority

NIEP believes that the conflict and overlap in regulation of EWGs that now exist between state and federal authority wastes time and money and increases regulatory risk for developers.

We propose therefore that the FERC be authorized to delegate to the state commissions its authority to approve market pricing for EWGs that are not affiliated with the purchasing utility, if the FERC, after appropriate notice and comment, finds that no negative impact on competition will result from this delegation. Under this proposal, to qualify for delegated authority, the state must adopt a plan for FERC approval which embodies established guidelines to protect against abuse of market power.

NIEP believes that this proposal would respond to states legitimate fear over loss of control of local markets, give states incentives to adopt "rules of competition" in order to qualify for delegation, mitigate jurisdictional conflicts that interfere with utility planning, impede market efficiencies, and increase costs for consumers.

VIII. ENVIRONMENTAL IMPACTS

PUHCA reform advances environmental protection by giving utilities a greater spectrum of choice in obtaining the new electric capacity most compatible with state and federal environmental standards. Just as competition makes EWGs more efficient in pricing, designing, and constructing power plants, it also encourages innovation and efficiency in complying with environmental standards.

Competition gives state regulators a market-tested benchmark for evaluating the pollution mitigation proposals of traditional utilities. When dozens of non-utility suppliers compete to provide both efficient and clean power, regulators can make real choices among alternatives. They are not limited to review of a single cost of service proposal from a single utility.

Finally, PUHCA reform allows wholesale generators greater flexibility in choosing sites by not forcing them to

co-locate with steam hosts. This flexibility will allow EWGs to locate plants where environmental impacts can be minimized.

#### IX. CONCLUSION

NIEP believes that PUHCA reform structured to prevent abuse of market power and promote free and fair competition offers maximum flexibility to utilities to select the kind of power which best meets their needs. Participation in wholesale generation markets is voluntary. Utilities needing new capacity, in conjunction with their state regulators, would be free to decide whether or not they want to:

- buy power from a wholesale generator;
- participate in wholesale generation markets; or
- build their own cost-of-service plant.

In short, PUHCA reform will give utilities additional supply options to consider in meeting their ratepayers needs without closing any existing ones. By exempting wholesale generators from regulation under PUHCA, Title XV of S. 1220 will create the opportunity for competition in power markets to flourish.

Reform of PUHCA will secure greater energy efficiency, billions of dollars in savings in coming decades, and a viable source of energy for the future. It will give regulators better market information in protecting rate-payers and give utilities more options in meeting their supply needs.

We look forward to working with Members of Congress in achieving a more efficient and secure energy future for the United States.

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## **THE RELIABILITY OF INDEPENDENT POWER:**

**OPERATING, SYSTEM, PLANNING, FUEL  
AND FINANCIAL**



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The National Independent Energy Producers (NIEP) is an association of companies that generate electricity for sale to utilities and develop cogeneration projects for a variety of users. NIEP membership is comprised of both publicly traded and privately held corporations which represent the entire spectrum of fossil fuel-fired and renewable technologies, including hydro, pumped storage, biomass, geothermal, wind, wood and waste-to-energy plants, as well as oil, gas and coal-fired cogeneration and independent generation facilities.

Cover photo courtesy of Coastal Power Production Company. Photo taken by Tom Sheppard.

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**THE RELIABILITY OF INDEPENDENT POWER:  
OPERATING, SYSTEM, PLANNING, FUEL AND FINANCIAL**

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## CHAPTER I. INTRODUCTION

The current debate over the future of the electric power industry encompasses the central issues of industry structure which have been simmering since the Public Utility Regulatory Policies Act of 1978 (PURPA) made competition in power markets a reality. PURPA encouraged the development of energy efficiency and diversification through cogeneration and renewable resources, called Qualifying Facilities (QFs). The proliferation of QFs has far outstripped original expectations, as the energy and economic efficiencies of these new generation units exceeded those built by utilities. In fact, QFs currently account for approximately six percent of the nation's generating capacity.

Several leading electric utilities have welcomed the opportunity to make supply decisions for new generation in a competitive market. As utility executives and managers, they see this new market as an opportunity for them to capture the cost savings, technological innovations and overall efficiencies which result from competition. Yet, other utilities continue to be invested in the monopoly status quo. They allege that change in the structure of the industry to promote competition would threaten its reliability. They further argue that the flexibility in financial arrangements available to independents somehow disadvantage monopoly utilities. The purpose of this report is to examine those claims.

Controversy about the impact of competition on industry structure is not surprising. Passed during the energy crisis, PURPA was not intended to foster competition in power markets, yet that is its most notable legacy. Much to everyone's surprise, QFs responded by offering large amounts of capacity (more than utilities required) at, or below, utilities' own avoided-costs of generation. This development led utilities and regulators to seek various types of competition to allocate the surplus supply. In the process they discovered that competitive systems would not only permit the allocation of QF capacity along some criteria, but also would provide a mechanism to make rational decisions about future supply (or demand) options, including a utility's own generation plans.

To play in emerging competitive power markets, both independent generators and utilities strain to meet the requirements of PURPA or to gain, or maintain, exemptions from the Public Utility Holding Company Act of 1935 (PUHCA). Some independent generators are constrained by availability of fuel and appropriate "thermal hosts" for QFs, especially in certain areas of the country. These non-utility suppliers argue that they should not be limited only to QF status since their plants provide electricity at a lower cost to the ratepayer.

Independent generators maintain that they should be encouraged to play a larger role in utilities' least-cost plans for the procurement of generation. Similarly, many utilities are attracted by an independent generators' ability to operate nationwide and to earn a market rate of return. These utilities wish not only to expand their markets, but see possibilities to diversify into a business in which they have experience—namely, building power plants.

The current geographic restrictions under PUHCA act as a barrier to greater opportunity, competition and reward for ratepayers, utilities and independent generators. PUHCA was passed in an era when geographically-dispersed utility holding companies evaded regulation and abused ratepayers and stockholders. It, along with the FPA, and the Securities Acts, was intended to close regulatory gaps and strengthen federal and state authorities. Clearly, PUHCA has achieved its goals—the majority of the multistate holding companies were broken up and the few that remain are subject to strict scrutiny and restrictions on investments.

PUHCA's reach is not limited to the United States but extends to any U.S. utility company's operations worldwide. Its remedies are sufficiently drastic to encourage scrupulous compliance, and exemptions from the Act are limited. However, the framers of PUHCA could not have predicted the evolution of competition in generation markets and the Act does not distinguish between entities with market power, such as integrated utility monopolies, and those without, such as independent power producers.

PUHCA stands as the last statutory barrier to competitive power markets in which utilities choose from a variety of alternatives to meet their load – through purchases from independent generators or other utilities, demand-side options or their own generation. However, under the existing ratemaking practices, some utilities are reluctant to rely on purchased power for any significant amount of new supply. They perceive the expansion of opportunities for independent power suppliers to threaten their own financial viability.

Power purchases are not treated as a capital expenditure item upon which a utility earns a return. Utilities do not lose money on

power purchases because they are entitled to recover all (prudent) costs through rates. But, clearly, current regulatory structures do not give a utility the same incentive to purchase power as to build its own generation. However, rather than focus on the issue of how utilities can be made profitable in competitive generation markets, some utilities prefer to shield themselves from competition by opting for the status quo. In a nutshell, these utilities claim that competitive markets threaten reliability. This report examines the impact on reliability, if any, of utility purchases from independent generators. The report finds the allegations of unreliability to be unsupported.

### Terms and Definitions

The emergence of a competitive market has spawned a new lexicon to describe the various players:

- The term “utility” continues to refer to a regulated entity possessing an exclusive franchise.
- The term “QF” applies to a qualifying facility which, by meeting the technical and ownership criteria established by the Federal Energy Regulatory Commission (FERC), benefits from PURPA’s mandate to utilities to buy its output as well as the exclusion of QFs from regulation under the Public Utility Holding Company Act of 1935 (PUHCA), the Federal Power Act (FPA) and state utility law.
- The term “independent power producer” (IPP), refers to a non-utility, non-QF generation facility which sells its output to a utility. IPPs do not qualify for any PURPA benefits. Indeed, few IPPs exist, due largely to the restrictions of PUHCA.
- Finally, the generic term “non-utility” or “independent” generator refers collectively to QFs and IPPs.

## CHAPTER II. POWER GENERATION RELIABILITY

Any discussion of reliability must confront a series of issues. This report will address five concepts of reliability:

- **Operating Reliability:** Do power facilities owned and operated by non-utility generators produce electricity less reliably than comparable facilities owned and operated by utilities?
- **System Reliability:** Will the entry of numerous independent generators into the wholesale generation market cause a breakdown in system coordination and integration?
- **Planning Reliability:** Will contractual non-utility power come on-line in the proper amount, at the proper time and at the projected cost, or will project attrition leave the purchasing utility short of needed capacity?
- **Fuel Reliability:** Has competition in generation markets led to an over-dependence on technologies which are subject to future fuel price volatility and supply interruptions?
- **Financial Reliability:** Are non-utility generators using the purchasing utility's credit to gain an unfair financial advantage via leveraging and risk shifting? Are they using too much leverage, and therefore, increasing the likelihood they will default on loans? If they do default on loans, how does that affect ratepayers?

### Operating Reliability

Physical or operating reliability is the easiest issue to address. Despite some well-publicized claims, data suggesting that facilities owned and operated by non-utility suppliers are less reliable than comparable utility facilities has yet to be produced. A 1989 study by the U.S. Congress Office of Technology Assessment (OTA), found no evidence to suggest that non-utility generators were less reliable than traditional utility power plants.<sup>1</sup>

The Gulf Coast Cogeneration Association, in a 1987 survey of cogeneration projects representing 3,126 megawatts (MW) of capacity in Texas, collected data showing that cogeneration projects maintained availability and capacity factors of 96 percent and 84 percent, respectively.<sup>2</sup>

Utilities surveyed by McGraw-Hill's Electric Utility Week newsletter reported that independent generators which sell electricity to utilities perform reliably. Niagara-Mohawk Power, which has about 469 MW of non-utility generation on-line in upstate New York, indicated that independent generators have provided a reliable source of energy. In addition, Central Maine Power, which has 425 MW of non-utility generation on-line, considers independent generation facilities as reliable as its own plants. The New Hampshire Public Utilities Commission has been informally monitoring 114 non-utility facilities and found that the facilities are meeting, or exceeding, their operating expectations.<sup>3</sup>

Two of the utilities with the most experience with purchased power, Pacific Gas & Electric (PG&E) and Virginia Power, have testified before their public service commissions that non-utility generation in their service territories perform reliably. PG&E filed data in a 1988 proceeding before the California Public Utilities Commission showing that 1,621 MW of non-utility firm capacity on-line in its service area were operating at a 94.8 percent capacity factor.<sup>4</sup>

William Berry, Chairman of Dominion Resources, the holding company for Virginia Power, noted in a recent speech, "the independent capacity already in service has had excellent reliability, with availabilities in excess of 90 percent. The capacity that we have bought competitively is essentially dispatchable and the larger units are under automatic generation control just like our own units. Our ability to control our generating system is as strong as ever."<sup>5</sup>

California and several other states recognize the potential higher reliability of independent generators by authorizing bonuses for projects which offer higher capacity factors than the utility's avoided unit. These bonuses represent a

strong economic incentive for independent generators to provide reliable plants.

Moreover, the nature of project financing provides a powerful discipline to ensure reliability. For example, each project generally goes through four independent engineering evaluations: the developer, the construction-lender, the equity participant and the suppliers of long-term debt. All have technical experts who intensively review every aspect of the design and construction plan of the project. This review is far more comprehensive than that given to a utility project in an after-the-fact prudence review by a public utility commission.

Although independent generators may not have a statutory obligation to serve, they clearly have a contractual obligation to serve, and a strong financial incentive to operate reliably both in their power sales agreement with the utility and in agreements with lenders. Independent generators are contractually obligated to deliver power according to specific operating standards. They suffer severe financial penalties if they fail to satisfy these commitments. They also rely on the same performance guarantees from equipment suppliers, such as General Electric and Westinghouse, that utilities rely on in building their plants.

In the event that an independent project fails, performance obligations flow to the mortgagor whose only recourse to recover its investment is to operate the facility and deliver power in accordance with the power sales agreement. However, independent generators have a strong, long-term incentive to keep a project from failing. In addition to the immediate financial impact, a failed project would hurt the developer's reputation and hinder its ability in the future to sign power purchase agreements.

In summary, selling power under fixed contract terms and prices creates strong incentives for reliable operation. Independent generators who are paid only for power actually delivered have a strong financial interest in the reliability of their facilities, stronger in many cases than utilities who may pass the costs of their mistakes to their ratepayers unless their regulatory commission objects. In the latter case, the cost of such mistakes represents financial risks to the utility shareholders and bondholders which may be greater than the risks of purchasing power.

### System Reliability

Another reliability issue is whether non-utility suppliers will either strain or cause a breakdown in the coordination among interrelated components of the integrated electric power system, such as transmission, economic dispatch and emergency service. Experience in other industries indicates that vertical integration is not required to maintain reliability.

William McCormick, Chairman and CEO of CMS Energy/Consumers Power Company, noted, "Natural gas and telephone service are just as important to consumers as electricity. Yet those industries are largely disintegrated. Nevertheless, their distribution sectors maintain high reliability and a strong service obligation to consumers through reasonable and enforceable contractual relationships."<sup>6</sup>

Utilities currently engage in a large amount of off-system purchases from multiple suppliers. For many years, utilities have purchased firm and non-firm (or economy) bulk power from other utilities on both a long and short-term basis. Although any power purchase necessitates increased coordination services, utilities have managed successfully to integrate these power purchases of varying durations and firmness into their system without jeopardizing reliability.

This has largely been achieved through voluntary cooperation among utilities under the aegis of regional reliability councils and the North American Electric Reliability Council (NERC). Independent generators have not yet been permitted to participate in these councils. Moreover, utilities have recently proposed agreements which would facilitate increased wholesale power sales within interconnected systems (for example, the Northeast Utilities/Public Service Company of New Hampshire merger and the Western Systems Power Pool).

Utilities will continue to purchase power from unrelated suppliers, including other utilities, IPPs and QFs. From the standpoint of coordination, there is no difference between off-system purchases from another utility and purchases from a non-utility supplier. Experience demonstrates that electric utilities have the technical capability and the experience to integrate multiple supply

points into their systems, while continuing to operate them reliably.

In addition, utilities take a number of steps to mitigate coordination-related reliability problems in contracting with independent generators. Power purchase contracts typically include performance guarantees, maintenance requirements and dispatch provisions designed to integrate the IPP/QF facility into the purchasing utility's system. Currently, most power contracts utilities sign with independent generators are for facilities which are partly or fully dispatchable or, for larger units, under automatic generation control. The power purchase agreements which utilities sign with non-utility suppliers, in most cases, are the result of arms-length negotiations in which the utility, as the monopsonist buyer, has sufficient leverage to insist on terms which assure effective coordination. In competitive procurement, utilities can and do design requests for proposals and evaluation criteria to favor projects which are likely to be highly reliable and relatively easy to integrate into their system.

Moreover, coordination concerns are most acute during power emergencies. Non-utility generators have good records in operating their facilities reliably during such emergencies. When Hurricane Gilbert struck south Texas in 1988, non-utility facilities in Houston Lighting and Power's service area stayed on-line without interruption during the storm threat and, in some cases, actually increased their net energy flows to the utility.<sup>9</sup>

During the December 1989 freeze in Texas, cogenerators in the Houston area provided the utility with 25 percent more power than required in their contracts.<sup>9</sup> During the 1989 California earthquake, cogenerators and other independent generators stayed on-line and helped PG&E to restore service quickly to consumers in the Bay Area. When Southern California Edison was subject to natural gas curtailments last winter, the utility requested and received increased output from independent generators.

#### Planning Reliability

The process of executing power purchase agreements between the host utility and the independent generators contains many checks and balances to ensure that power will be delivered on time and in the amount required. The utility's

first line of defense is the procurement evaluation system which pre-qualifies bidders and takes into account their ability to complete projects on time and to operate them dependably over the life of the contract.

Many utilities incorporate screening devices in their competitive procurement systems to weed out potentially unreliable suppliers. Such devices include requirements for: earnest money fees, letters of credit, detailed project descriptions which demonstrate mature fuel supply and siting arrangements, and an examination of the project completion and financial viability record of the developer.

The second line of defense are standard contracts with construction, financing and performance milestones to monitor and encourage dependable development. Even with the most careful project selection and contracting, some project attrition will occur, whether an independent or a utility develops the project. Therefore, utilities adopt other protections to guard against power shortages from attrition: over-subscription for capacity, programmed slippage of deadlines for when the capacity is due on-line and, finally, the right to buy failing projects. The purchasing utilities also try to assemble a diverse portfolio of non-utility projects of differing sizes, fuel sources and ownership so that the loss of any one can be absorbed within normal reserve margins.

A recent survey of 172 projects selected through competitive bidding since 1984 shows that the vast majority of projects (85 percent) are in development, under construction or on-line. Less than 15 percent of those projects have been canceled, most of them very early in the process, and with little or no impact on utilities' supply plans.<sup>10</sup> These numbers compare favorably with utility performance for planned generating units.

#### Fuel Reliability

Opponents of the competitive power industry have also expressed concern that utilities will lose control of their fuel mix and become overly dependent on gas-fired projects vulnerable to price fluctuations and supply interruptions. However, independent generators have no inherent preference for a particular technology or fuel. Instead, they respond to market needs.

Utilities control the specifications, terms and conditions of the competitive procurements, not independent generators. The more varied and flexible the stated preferences for technology and fuel, the better the opportunity for competition to work.

For example, in competitive procurements through May 1991, independent generators have offered a diverse fuel mix. Twenty-six percent of the megawatts bid by independent generators were coal. Gas accounted for 47 percent of the megawatts bid.<sup>11</sup> In addition, independent generators have contributed to reliability by pioneering efficient combined-cycled cogeneration plants, clean coal technologies and commercial applications of renewable resources. Also, some of independent power plants can adapt to major changes in fuel supply markets because of fuel-switching capability.

Finally, many utilities are contracting for combustion turbines for peaking capacity because they have enough baseload capacity to meet current needs well into the 1990s.<sup>12</sup> It is these market factors, not any bias of the competitive generation system itself, that have led to preference for gas-fired facilities in recent years.

Moreover, utilities' construction plans are concentrated on natural gas plants. The Utility Data Institute reports that almost two-thirds of the newly announced plants planned by utilities will be fueled by natural gas.

#### Financial Reliability

Perhaps the most misunderstood component of the overall reliability of non-utility generators is the integrity of the financing structures for such projects. These projects rely on asset-based project financing where the developers pledge the asset and part or all of the project's revenues to lenders. By contrast, utilities finance construction on the strength of their overall corporate balance sheet. Opponents of non-utility generators argue that highly leveraged capital structures upon which independent generators rely are inherently more risky than those based on rate-of-return regulation.

This contention starts with the mistaken assumption that all independent generators rely on levels of debt in excess of 90 percent,<sup>13</sup> and posits the following:

- Argument #1 – Independent generators can sustain these high levels of debt by shifting risk to utilities without compensation;
- Argument #2 – Therefore, independent generators gain an artificial cost of capital advantage over utilities; and,
- Argument #3 – Finally, this profit-driven reliance on high levels of debts causes independent generation projects to be financially unstable.

It is also important to recognize three additional fundamental assumptions or myths underlying these arguments:

- Power contracts require utilities to make fixed payments to independent generators under all circumstances;
- Regulators will directly or indirectly force utilities to buy power from independent generators; and,
- Independent generators are monolithic and can exercise market power.

The fallacy of these arguments and assumptions lies in the implicit lack of understanding of how capital markets assess and assign risks to deliver project financing at the lowest costs. They also reflect a misinterpretation of the roles of regulators, utilities and independent power suppliers in competitive power markets.

Argument #1 – Independent generators can sustain high levels of debt by shifting risk to utilities without compensation.

It is important to dissect this argument into its components. First, not all independent generators rely on "high" levels of debt – there certainly is no magic number for the debt-equity ratio of a power project. As with all profit-maximizing firms, independent generators seek levels of debt and equity which minimize their cost of capital. The correct ratio will be determined by the specifics of the project and its power sales agreement.

Second, independent generators actually shift risk away from utility ratepayers. It is true that bankers and other lenders look to the quality and credit worthiness of the purchaser of a

product, in this case the utility purchasing electricity, to determine the financial stability of the product provider and project to be financed. This evaluation imposes a conditional obligation on the purchaser to ensure a revenue stream to the independent generator to repay its debt. It is simply not accurate in today's competitive markets to equate this conditional obligation as a misallocation of risk away from the independent generator and to the utility shareholder, debt-holder and ratepayer.

Economic efficiency dictates that no entity be required to bear risks for which it is not appropriately compensated or which are beyond its control. The financing process requires independent generators to clearly identify the sources of risk inherent in the project and attempt to manage them by assigning them to parties best able to bear those risks.

Any discussion of "misallocation of risk" must catalogue risks involved in utility purchases of independent power. Table 1 illustrates how risks are shifted from utilities and their ratepayers to non-utilities under typical contracting terms. In addition, following is a discussion of the four major types of risk: demand risk, construction and operating risk and regulatory risk.<sup>13</sup>

First, ratepayers bear the demand risk no matter who builds new capacity. A recent article noted if generating capacity turns out not to be needed because demand has not materialized, "the utility is still obligated to pay (earnings to bondholders and shareholders if it builds; capacity payments, at least, to sellers if it buys)."<sup>14</sup> Clearly, utility bondholders and shareholders bear prudence risk for the utility management of resource acquisition in the face of demand uncertainty. Utilities may manage these risks through least-cost planning processes, competitive procurement or through diversifying suppliers and supply points.

Second, with respect to construction and operating risks, utilities use a variety of devices to allocate risk to the seller:

- Requiring front-end deposits to guarantee the project is constructed on time. For example, Virginia Power requires that independent generators put \$30/kilowatt in

escrow within six months of signing the power purchase contract;

- Specifying minimum standards for equipment, warranties and guarantees provided by equipment suppliers;
- Requiring an operating escrow account which can be drawn on if the system is damaged or the equipment does not perform to contract levels;
- Specifying annual testing of equipment to determine if it meets contract standards, with penalties if it does not; and,
- Requiring security interests in fuel supply contracts.

In short, the risk of construction cost overruns is eliminated by signing a long-term contract with a fixed price formula and including performance and security provisions such as those described above. These performance-based contracts, in which profits are directly related to plant availability, give independent generators strong incentives to operate plants at optimum standards. It is no surprise, therefore, that the operating records of independent plants to date, by all accounts, have been remarkably strong.

Finally, when one weighs the relative regulatory risk for utilities of building versus buying power, the balance can also tip in favor of purchased power. Indeed, one of the major reasons utilities turned to purchased power in the 1980s was fear of prudence reviews and regulatory disallowances of their own construction programs. State commissions have tended to look favorably on purchases from independent generators because their contracts are market-tested through competition.

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*Economic efficiency dictates that no entity be required to bear risks for which it is not appropriately compensated or which are beyond its control.*

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Although the credit rating agencies of Standard and Poors and Moody's Investor Service, in recent reports on this issue, cited the risk of state commission refusal to pass through the costs of third party power contracts, this concern is greatly exaggerated. Utilities are not obligated to sign contracts with independent power producers.

In addition, state regulators are far less likely to review costs disciplined by the market in an open competitive process than they are to revisit costs proposed by utilities in more sheltered administrative proceedings. This is even more true in states which give pre-construction approval to contracts signed with independent generators.

Finally, many contracts contain "regulatory out" clauses which work to hold the utility purchaser harmless if pass-through of the contract costs was not approved.

**Argument #2** – Through high levels of debt, independent generators gain an artificial cost of capital advantage over utilities.

This argument is composed of two parts:

- 1) Debt is cheaper than equity because of the tax treatment of debt and lower overall riskiness; and,
- 2) The cost advantage conferred on independents permits them to be less efficient.

**TABLE 1**

**COMPARISON OF RISK ALLOCATION**

**UNDER TRADITIONAL  
RATEMAKING:**

**UNDER INDEPENDENT CONTRACT POWER:**

UTILITY & RATEPAYERS SHARE RISK	RISK SHIFTS TO DEVELOPER IN MOST OR ALL CASES	RISK SHIFTS TO DEVELOPER IN SOME CASES OR TO SOME DEGREE
Construction Costs		
Fuel Costs		
Interest Rates		
Project Failure		
Project Delay		
Demand for Power		
Financial Risk: Non-Performance		
Imprudent Management		
Permitting		
Environmental Compliance		
Acts of God, Force Majeure		
State Regulatory		

The simple assumption that a greater reliance on debt automatically lowers the cost of capital demonstrates a failure to appreciate the complexities of project finance. Utilities have traditionally satisfied their shareholders with a regulated return on equity in the range of 11 to 13 percent based on the public market's perception of the financial and business risks. This rate-of-return assumes a common equity investment of about 40 percent of total capital requirements, with the balance of a utility's financing provided by a combination of debt and preferred stock. The overall capital structure of the utility must be approved by the regulator. Furthermore, utilities have little incentive to push for changes in their debt-equity ratio, since their shareholders are able to earn a guaranteed rate-of-return on equity.

By contrast, independent generators typically acquire capital through an asset-based financing technique known as "project financing." In this capital structure, the sole source of both repayment of debt and the return on equity is the revenue generated by the asset financed (i.e., a power plant), rather than the credit of the owner of the asset, as in the case of most utilities. As a result, the project developer, working with the debt and equity providers, analyzes and allocates the various project risks in a competitive environment, with the resulting rates-of-return reflecting the risks assumed by each type of capital provider.

To date, the most efficient allocation of risk in project financing has resulted in a greater proportionate share of debt in the capital structure. However, the cost of both debt and equity capital is higher for independent generators than for utilities, reflecting the premiums arising from the risk allocations described above.

In addition, independents must raise capital before construction and commercial operation of a facility through a combination of loans and public or private stock issuances or through limited partnerships. Moreover, capital markets insist on credit enhancements, such as debt service reserve funds, working capital, and operations and maintenance reserves which divert cash away from, and are costly for, equity investors.<sup>16</sup> These considerations make the cost of equity greater for independent generators than for a utility with a franchised service territory. Lower overall equity cost (by lowering the amount of

equity in the project) enables projects to be competitive.

Borrowing rates vary, among other things, on the amount of the borrower's equity at risk. The usual rule of thumb is the less equity at risk, the higher the debt cost. In financing power projects where the leverage is greater than 75 to 80 percent, the borrower generally pays a premium on the amount borrowed in excess of a "conventional" leverage amount. Thus, the alleged financial advantages of higher leverage can be, in many cases, substantially nullified by the premium imposed on such leveraging.

In addition, any cost advantage is further evaporated because the term of debt is shorter for independent generators than for utilities. Typically, independents borrow for 12-15 years, while utilities generally borrow for 30 or more years. Finally, utilities finance on corporate balance sheets which reflect revenues and expenses not directly related to power production, such as transmission, distribution and other services. On the other hand, independent projects generally exclusively base cash flows on power sold and performance.

Some opponents of independent power also argue that the alleged financing advantages of high debt levels permits projects to be inefficient while remaining cost competitive. This claim is ludicrous. As discussed above, there is no inherent or consistent cost advantage gained by independent generators. Furthermore, the suggestion that independents will use the supposed "price cushion" to mask inefficiencies ignores the existence of highly competitive power markets, where the level of competition drives down price. As of May 1991, in all competitive "Requests for Proposals" issued to date, eight times as much generating capacity was bid as requested.

The data in Table 2 illustrates a typical utility's financial structure and the cost to raise \$1,000 of capital. The utility's cost of investment is then contrasted to a "typical" independent financing structure. The formula assumes a corporate tax rate for both utilities and independent investments of 33 percent. Table 2 demonstrates that, given realistic assumptions on rates of return on debt and equity, it is easy and plausible to create a scenario where the utility, not the independent generator, has a financing advantage.

**TABLE 2**  
**COST OF CAPITAL ANALYSIS**  
**TYPICAL UTILITY CAPITALIZATION**

	Capital Distribution	Cost of Capital
DEBT	\$500	10.0% Interest rate
PREFERRED STOCK	100	9.5% dividend rate
EQUITY	400	12.5% return on equity
TOTAL	\$1,000	
		Revenue Requirement
DEBT	Interest Rate x Debt amount as Fraction of 1000 (10 x 0.5 = 5)	\$5.00
PREFERRED	Dividend Rate x Stock Insurance as Fraction of 1000 (9.5 x 0.1 - 0.95) Divided by (1.00 - 0.33 (tax rate))	1.41
EQUITY	Required ROE x Stock Insurance as Fraction of 1000 (12.5 x 0.4 = 5.0) Divided by (1.00 - 0.33 (tax rate))	7.46
		<u>\$13.87</u>

A utility must earn \$13.87 in revenue to service each \$100 of capital using this mix.

**TYPICAL IPP CAPITALIZATION**

	Capital Distribution	Cost of Capital
DEBT	\$800	11.0% Interest rate
EQUITY	200	20.0% return on equity (33% tax rate)
TOTAL	\$1,000	
		Revenue Requirement
DEBT	Interest Rate x Debt Amount as Fraction of 1000 (11 x 0.8 = 8.8)	\$8.80
EQUITY	ROE x Stock Insurance as Fraction of 1000 (20 x 0.2 = 4) Divided by (1.00 - 0.33 (tax rate))	5.97
		<u>\$14.77</u>

An IPP must earn \$14.77 in revenue to service each \$100 of capital using this mix. In this case, the cost of capital for the IPP is 6.5% higher than for the utility, reflecting the higher cost of capital in a competitive environment.

Simply put, independent generators receive no "magical" cost advantage from the use of debt. Independent generators generally rely on relatively high levels of debt as they seek to minimize costs in very competitive markets. Independent projects must seek meaningful costs savings from lower overall construction costs resulting from: 1) shorter construction periods, 2) greater discipline in the acquisition of engineering services, fuel and equipment, 3) more efficient use of fuel, or 4) economies in equipment purchase.

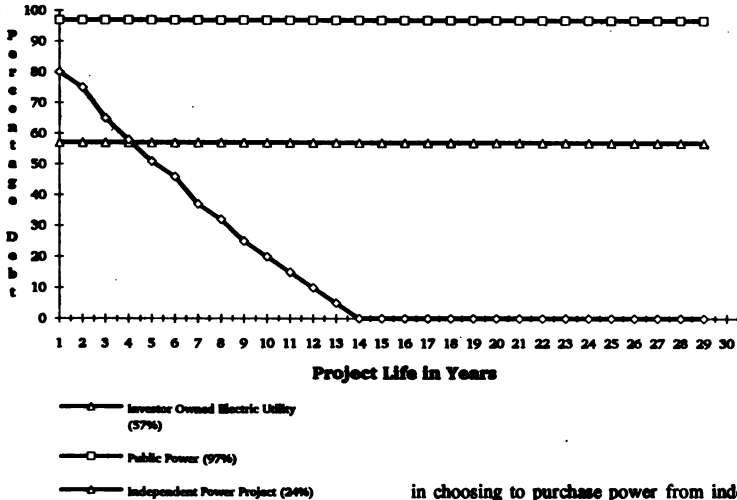
**Argument #3** - The reliance on high-levels of debts causes projects to be financially unstable.

A higher debt-equity ratio does not lead to unreliable financial structures. First, the discipline of the financing process itself increases the financial accountability of projects. Banks require developers to clearly identify the sources of risk inherent in the project and attempt to manage them by assigning them to the parties best able to bear those risks. In addition, projects undergo intensive review by the lenders' own technical experts, such as independent architect and engineering firm review, to ensure that projects will perform well enough to cover their loans. Moreover, lenders require creation of a number of reserve accounts to ensure that the debt is repaid over the life of the financing.

Second, project financing is asset-based. Project developers pledge the asset and part or all of the project's revenues to lenders. Analogies to leveraged buy-outs, the S&L crisis, and the financial scandals of the 1920s, '30s and '80s are unfounded and irrelevant. First, no government guarantee of the power plant investment exists. Furthermore, project financing is based upon the value of specific, tangible assets (the powerplant), while these unstable financial structures alluded to above staked corporate balance sheets on the value of speculative or sham assets.

TABLE 3

## DEBT BY OWNERSHIP TYPE



Third, independent generators do not necessarily maintain high levels of debt over the life of the project. As project cash flow retires the debt, the debt-equity ratio declines. When the debt is retired (usually 12 - 15 years), 100 percent of the project's value belongs to equity investors. By contrast, utilities generally maintain a steady debt level because they finance on a corporate, rather than project, level. Table 3 represents debt levels by ownership type for a typical project-financed IPP, a typical investor-owned utility (IOU) and a typical public power entity.

The independent generator starts with 80 percent debt, which declines as it is repaid until it reaches zero percent in year 15. The independent averages 24 percent debt over the life of the project. In some cases, after the debt is retired, the developer may refinance all or a portion of the debt. Even assuming refinancing occurs, the average debt level over the life of the project will be less than 50 percent. The IOU debt level averages 57 percent. The typical public power entity maintains a debt level of approximately 97 percent.

Finally, utilities can, and do, consider the financial reliability and stability of developers

in choosing to purchase power from independent generators and take measures to safeguard against financial failure. Purchases from independent power producers are voluntary. If a project owner is unable to meet its financial obligations, clearly the financing parties will seek to mitigate their losses by finding a new owner or operator for the facility or restructure the capital arrangements to reflect revised expectations.

In addition, many power sales contracts specify that in the event of a bankruptcy, the utility may take over and continue to run the project. All of this helps to ensure that the project can continue to produce power economically over the life of the contract without interruption for consumers. However, we know of no IPP or QF which has failed to meet its power supply obligations as a result of financial default. Moreover, state utility commissions currently have the authority to review the financial structure of independent generators who wish to sell to utilities in their jurisdiction.

*Finally, utilities can, and do, consider the financial reliability and stability of developers in choosing to purchase power from independent generators and take measures to safeguard against financial failure.*

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### CHAPTER III. CONCLUSION

Over the last few years, there has been a fog of rhetoric surrounding the reliability debate. For some utilities and states, the reliability of purchased power is simply not an issue—independent generators have already passed the test.

Utilities in Virginia, New Jersey, New York and New England and other areas where the demand for new capacity has been acute in recent years, rely heavily on contract power and generally give non-utility generators high marks for reliability.

It is also worth noting that the state utility commissions have already conducted a kind of referendum on the reliability of the non-utility generation "experiment." By May of 1991, utilities or public service commissions in 28 states had either adopted competitive bidding as the primary method for acquiring new generation or had it under development.

In summary, NIEP believes the evidence shows that non-utility generators are a dependable source of power. Reliability is as important to independent generators as it is to utilities—simply put, independents do not get paid unless they perform. Arguments to the contrary do not stand up very well under scrutiny. Allegations of threats to reliability are refuted by the data available.

Claims of independent leveraging advantages also vanish upon close examination. These generators are already producing a more stable and efficient supply of electricity to keep the United States competitive in global markets. The record to date shows that the market-based incentives of contract generation have ensured that independent generators develop reliable power facilities, on schedule, at a competitive price.

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*Reliability is as important to independent generators as it is to utilities—simply put, independents do not get paid unless they perform.*

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**NOTES**

1. Congress of the United States, Office of Technology Assessment, *Electric Power Wheeling and Dealing: Technological Considerations for Increasing Competition*, OTA-E-409, (Washington, DC, May 1989.) Page 9.
2. Gulf Coast Cogeneration Association, *Survey of Cogeneration in Texas*, 1987.
3. *Electric Utility Week*, January 2, 1990, page 12.
4. J. Hamrin, "Non-Utility Power and the Reliability Issue," *The Electricity Journal*, June 1989, Volume 2, Number 5, page 17.
5. Remarks of William Berry, Chairman of Dominion Resources, to the Congressional Staff Briefings on PUHCA Reform, Washington, D.C., February 21, 1991.
6. Testimony of William McCormick, Chairman and CEO of CMS Energy/Consumers Power Company, before the Committee on Energy and Natural Resources, United States Senate, November 9, 1989, page 6.
7. The FERC Transmission Task Force's Report to the Commission notes that bulk or wholesale sales of power, excluding sale to requirements customers (captive wholesale customers), account for 22.4% of the megawatts ultimately sold at retail.  
  
Federal Energy Regulatory Commission, *The FERC Transmission Task Force's Report to the Commission: Electricity Transmission: Reality, Theory, and Policy Alternatives*, (Washington, DC, October 1989) Page 18, Table 2-7.
8. J. Hamrin, page 19.
9. *Electric Utility Week*, January 29, 1990, pages 12-13.
10. *Robertson's Current Competition*, Volume 2, Number 4, February 1991, pages 2 and 13.
11. *Robertson's Current Competition*, Volume 2, Number 5, May 1991, pages 8 and 9.
12. See remarks of Allen Franklin, CEO of Southern Company Services, *Energy Daily*, February 23, 1990, page 4.
13. See generally, D. Raboy, "Risk Shifting and Its Consequences in the Electric Power Industry," prepared for the Electric Reliability Council, May 29, 1991.  
  
More typically today, NUOs rely on 75 to 80 percent debt paid down over a 12 - 20 period. However, some projects will use more or substantially less debt (projects may be 100 percent equity financed).
14. R. Naili and B. Sharp, "Risky Business? The Case for Independents," *The Electricity Journal*, Volume 4, Number 3, April 1991, page 56.
15. See generally, "Letter to the Honorable J. Bennett Johnston, Chairman, US Senate Committee on Energy and Natural Resources, from T. DePre, Donaldson, Lufkin & Jenrette," May 17, 1991.
16. See generally "Letter to the Honorable J. Bennett Johnston, Chairman, US Senate Committee on Energy and Natural Resources, from P. Miller, Goldman, Sachs & Co." April 18, 1991.

**SUMMARY OF THE TESTIMONY OF  
THOMAS E. WHITE, JR.  
BEFORE THE  
U.S. SENATE BANKING COMMITTEE  
SUBCOMMITTEE ON SECURITIES  
SEPTEMBER 17, 1991**

**Enron Power Corporation strongly supports reform of the Public Utility Holding Company Act of 1935, as reflected in Title XV of the National Energy Security Act, S.1220.**

Enron Power is an experienced and successful cogenerator. Due to the lack of steam hosts for cogeneration operations, the growth of our business requires that we construct "independent power producers" (IPP's) rather than PURPA "qualified facilities." Unlike qualified facilities, IPP's are not exempt from the Public Utility Holding Company Act (PUHCA). Therefore, by operating IPP's, Enron Power and our parent, Enron Corp., could become subject to PUHCA's organizational constraints, investment limitations, and reporting requirements. Unless specific exemptions are granted on each IPP that we construct, PUHCA could result in the SEC ordering Enron Corp. to divest itself of the largest natural gas business in the country and other significant assets. PUHCA is a serious impediment to the development of both Enron Power and the entire independent power industry.

The United States is facing massive needs for new generation capacity. The Department of Energy (DOE) estimates that 134,000 megawatts of additional capacity will be required nation-wide in the next decade. The Public Utility Commission of Texas estimates that about 12,000 megawatts will be needed during this period in the State of Texas alone. By the year 2010, the DOE estimates that 200,000 megawatts of additional capacity, the equivalent of 200 large generating stations, will be needed. If it is exempted from PUHCA, the independent power industry can supply a large amount of this capacity--much more than the 38,000 megawatts currently provided--and thus ensure an adequate supply of electric power will be available.

According to data from the Edison Electric Institute, real electricity prices increased 36 percent between 1973 and 1989. Independent power can stop this upward spiral by providing inexpensive power. For example, the plants currently operated by Enron Power produce electricity for an average of three to four cents per kwh. This compares to the 1989 U.S. average retail electricity price of 6.5 cents per kwh.

PUHCA reform will allow consumers to enjoy more of this low cost power. Utilities will not purchase electricity from IPP's unless the power is priced lower than the utility's avoided cost. Therefore, IPP's will only be built if they will commit to

produce power that will be less expensive than the power produced by their utility customer.

Currently, the market environment for wholesale electric generation is very uncompetitive. Opportunities for non-utilities to enter the market are limited. In order to meet PUHCA requirements, IPP owners must adopt uncommercial ownership structures. For example because of PUHCA constraints, Enron Power will own only a minority share in the generating facility that we are building in Milford, Massachusetts, and will not have operating control over the plant. PUHCA reform will greatly improve the competitive environment by eliminating these nonsensical requirements. It will also lead to lower costs because of the innovation and technological improvement that competition always creates.

PUHCA reform will not change the electric industry's regulatory framework. The jurisdiction and authority of FERC, SEC, and state regulatory commissions over utility financial affairs will be maintained. Consumers and utility stockholders will continue to be protected by the same mechanisms that exist today.

The financial condition of utilities will not be endangered by PUHCA reform either. Purchases from IPP's are less risky and require much less capital than the construction of power plants by utilities. The project financing used by IPP's does not result in an inappropriate degree of leverage. In fact, over the life of a typical IPP, it will be financed with a smaller proportion of debt than utility-owned facilities.

Because non-utility generation is generally natural gas-fueled, it has less environmental impact than most other types of generating technology. Stack emissions from gas-fired combined cycle plants are less than half of those from coal-fired power plants, which exceed one ton of emissions per megawatt hour. Independent power and environmental requirements for cleaner fuels are expected to significantly increase the demand for natural gas. In its "Outlook for Natural Gas" publication, Enron estimates that gas-fired generation will increase the annual demand for natural gas by up to three trillion cubic feet by the year 2005. Enron also estimates that the United States has more than a 60 year supply of natural gas. The additional demand for gas will cause increases in production and stimulate the economy.

In summary, PUHCA reform, and the IPP development that will result from it will benefit the country in several ways. Independent power will ensure adequate supplies of electricity at affordable rates. Lower electric rates will lead to lower more competitive prices for American products. IPP's built abroad will boost exports and increase federal tax revenues. Together improved competitiveness, increased exports, and the expanded use of natural gas mean more American jobs, a stronger economy, and a cleaner environment.



U.S. SENATE BANKING COMMITTEE

SUBCOMMITTEE ON SECURITIES

September 17, 1991

ORAL STATEMENT OF THOMAS E. WHITE, JR.

on behalf of

ENRON POWER CORPORATION

Mr. Chairman and Members of the Securities Subcommittee:

My name is Tom White. I am the Chairman and Chief Executive Officer of the Enron Power Corporation. I appreciate the opportunity to testify in support of the proposed amendments to the Public Utility Holding Company Act (PUHCA) as reflected in Title XV of S.1220, the National Energy Security Act. This legislation will help maintain reasonable electric prices in this country and will improve our ability to compete in the supply of electricity abroad.

We at Enron Power bring a unique perspective to the PUHCA debate; we have a long track record of design, construction and operation of qualified facilities under PURPA in the wholesale generating market. We are breaking new ground with an IPP project in Milford, Massachusetts starting construction and currently under review by the SEC for a PUHCA exemption. In Teesside, England we are constructing one of the world's largest cogeneration plants at some 1,725 megawatts in capacity. Our England experience is relevant because it is a 50,000 megawatt market, about the size of Texas, which has no vertically integrated utilities, with an open access transmission system and 100% purchased power; free market provisions far beyond anything contemplated in the reforms to PUHCA provided for in the bill before your subcommittee. I am happy to report to you that all the lights are burning brightly throughout

England and the message is clear; enhancing growth in the independent generating sector endangers absolutely no one and benefits every one.

With our business experience at Enron Power providing the evidence, let me address some of your questions regarding this issue. First, a strong and viable independent power sector is vital to providing the massive amount of additional generating capacity our country needs in the next decade. Estimates of the future demand vary, but both the Department of Energy and the North American Electric Reliability Council forecast capacity requirements in excess of 100,000 megawatts by the year 2000. Utilities can not, and should not, meet these capacity needs in-house. During 1990 non-utility generators installed 6,356 megawatts of capacity, bringing the total amount in operation nationwide to 38,000 megawatts. With FURCA reform, we will be free to provide much more of this reliable and reasonably priced power. The diversity and competition represented in independent market is healthy and represents savings to the rate payer. Every one of our power sales agreements is below the avoided cost of the utility we supply, and I would put our availability rates and the quality of our plant design and construction up against any utility in this country. If it were any other way, the utility would never enter into a contract with us in the first place.

Regarding the impact of this legislation on the competitive

In addition to reducing electric rates, PUHCA reform will benefit this country in several other ways. First, as I have mentioned, it will assure an adequate supply of electric power. Many utilities are reluctant to build additional capacity due to financial strain and regulatory disallowances. Obviously, supply must keep pace with demand. Second, by lifting PUHCA restrictions, foreign investment opportunities--like our Teesside project--will allow greater export of American technology. This will increase tax revenue because we pay taxes on our earnings from our overseas operations. Finally, as our history with environmentally benign gas-fired cogeneration plants demonstrates, independent power is good for the environment.

You have also asked about the impact of PUHCA reform on the financial health of utilities and statutory protections for utility rate payers and stockholders. Those who argue that PUHCA reform will bring greater dependence on independent power and, therefore, greater risk because we are less reliable or dependent upon higher leverage financing miss a basic fact. We sell power under contract to utilities. They are free to extract whatever reliability standards they wish, or financial stability measures they require in those contracts. The risk in honoring those contracts rests on us and our shareholders, not on the rate payer. The leverage "issue" is a classic red herring. Financing arrangements do not make independent power unreliable. IPP's are financed with typical forms of project financing. Over the life of our facilities, we

Teesside plant in England. Without PUHCA reform many companies will refuse to run the PUHCA gauntlet and the result will be a much tighter supply of power and higher costs to customers.

You have asked about the impact of PUHCA reform on electric rates. The answer to this question is very simple. Rates will be lower with PUHCA reform because IPP's will only be built if they are the least cost alternative. Data from the Edison Electric Institute reveals that electric rates increased 36 percent in real terms between 1973 and 1989. Independent power can stop this spiral. My company's plants currently produce power which has an average price of three to four cents, lower than the national average retail price of 6.5 cents and much lower than the incremental cost of power from some new utility-owned plants. PUHCA reform will allow us to supply more of this low-cost power and minimize future rate increases.

Lower electricity prices are important to the economy because they make American industry more competitive and thereby cut imports. Additionally, there is a multiplier effect associated with electric rate increases. Dollars spent on needlessly high electricity costs are not available for savings, investment, and the consumption of other goods. The lower rates that will result from PUHCA reform will lead to a stronger economy, more jobs, and a better standard of living.

In addition to reducing electric rates, PUHCA reform will benefit this country in several other ways. First, as I have mentioned, it will assure an adequate supply of electric power. Many utilities are reluctant to build additional capacity due to financial strain and regulatory disallowances. Obviously, supply must keep pace with demand. Second, by lifting PUHCA restrictions, foreign investment opportunities--like our Teesside project--will allow greater export of American technology. This will increase tax revenue because we pay taxes on our earnings from our overseas operations. Finally, as our history with environmentally benign gas-fired cogeneration plants demonstrates, independent power is good for the environment.

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will actually use less debt than utilities. In the case of Enron Power, we bring to the table strong reliability numbers and the financial stability of a \$10 billion parent corporation balance sheet.

Additionally, nothing about PUHCA reform threatens the financial integrity of electric utilities, or makes them riskier investments. To the contrary, it is less risky for a utility to purchase power than to build its own generating capacity. Let me underscore that point by noting that the financial calamities faced by many electric utilities in the past decade were caused by cost overruns and delays at utility-constructed power plants, not by purchased power.

State regulator concerns that somehow PUHCA reform will diminish their ability to protect rate payers are without basis. The regulatory structure post-PUHCA reform will have FERC regulating wholesale rates and states regulating retail rates just as they do now. Purchased power contracts will still be driven by utility avoided cost structures controlled by the states. PUHCA reform is not about deregulation, it is about eliminating SEC intrusion in an independent power market that bears no semblance to the 1935 situation the Act was intended to correct. State PUCs' ability to control cross-subsidization and affiliate transactions will not be limited by PUHCA reform. This is an issue left appropriately with the states. Nothing in PUHCA reform will expose rate payers to the

abuse that PUHCA was intended to eliminate. Nor will the proposed revisions disturb the investor protections that also drove the original need for PUHCA. The SEC will still have full jurisdiction over utility holding companies. Reporting requirements will not be changed, so investors will continue to have access to all of the accounting and operating data that is available today.

Finally, let me deal with your question about the environmental impact of independent power. IPP's will be subject to exactly the same emission standards as other generating facilities. Enron Power's cogeneration plants have an enviable environmental record because they rely on environmentally-benign natural gas as a fuel. Natural gas, which is in plentiful supply, produces less than one-half of the stack emissions of coal. Also, because IPP's will operate in a competitive, rather than a profit-regulated environment, we will have an incentive to be as efficient as possible, including designing and operating our plants in such a way that fuel use will be minimized.

Let me summarize by saying that the PUHCA reform legislation under consideration before this subcommittee is absolutely necessary to sustain the independent power sector in the future, and independent power is critical to meeting this country's future energy needs. The proposed reform threatens no one: not the electric industry, not regulatory bodies at federal or state level, and most of all not the rate payers of this country. I strongly urge you to pass



this vital legislation.

Thank you.

**SUMMARY OF TESTIMONY  
OF KEYS A. CURRY, JR.,  
EXECUTIVE VICE PRESIDENT OF  
DESTEC ENERGY, INC.**

**Before The**

**SUBCOMMITTEE ON SECURITIES OF THE  
COMMITTEE ON BANKING AND URBAN AFFAIRS**

**Concerning**

**TITLE XV OF S.1220  
THE NATIONAL ENERGY SECURITY ACT OF 1991**

**September 17, 1991**

Keys A. Curry, Jr., is Executive Vice President of Destec Energy, Inc., a leading independent power producer based in Houston, Texas. Destec has interests in ten operating power projects with total rated capacity of 960 megawatts (MW). Those projects have received numerous awards for efficiency and for promoting environmentally-sound energy generation.

Destec, together with a broad coalition of consumer groups, environmental interests and other independent power producers, has developed a Fair Competition Amendment to Title XV of S. 1220. The Amendment, which is attached to and discussed in Mr. Curry's testimony, corrects two fatal defects in Title XV that will prevent it from achieving its goal of a competitive wholesale electricity market. Those defects are the lack of access to essential transmission facilities and the potential for abusive self-dealing between utilities and unregulated utility affiliates.

The Fair Competition Amendment authorizes the Federal Energy Regulatory Commission (FERC) to grant requests for transmission of wholesale electricity where, after notice and opportunity for hearing, FERC determines that the requested transmission will promote competition without diminishing the reliability of electricity service. The Amendment also withholds PUHCA exemption from any wholesale power producer that enters into self-dealing power sales with an affiliated electric utility. Destec urges the Subcommittee to support this Amendment to Title XV, and further asks Subcommittee members to communicate that support to the sponsors of S.1220, Senators Johnston and Wallop.

A truly competitive market for wholesale power production could provide substantial benefits to the Nation's ratepayers,

**Summary Testimony of Keys A. Curry, Jr.  
Destec Energy, Inc.  
September 13, 1991  
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the Nation's energy security and the Nation's environment. Destec accordingly supports Title XV's stated objective to "foster competition in the electric utility industry." As reported by the Committee on Energy and Natural Resources, however, Title XV will not achieve that critical objective. Title XV correctly recognizes that the burdensome requirements of the Public Utility Holding Company Act (PUHCA) are an obstacle to achieving a competitive wholesale electricity market, and the Title removes those barriers by exempting non-utility wholesale power producers from PUHCA. However, removing PUHCA barriers alone will not make wholesale competition possible.

In order to achieve competition, wholesale power producers must be able to get their product to market; yet Title XV does nothing to ensure fair access to utility-controlled transmission facilities. Under current law, the electric utilities that have monopoly control over the Nation's electricity transmission lines can deny transmission access to their competitors in the wholesale power market. Wholesale power generators are routinely denied access. At present, those denied access have no effective recourse because the Federal Energy Regulatory Commission is effectively prohibited from ordering transmission access if the requested transmission would promote competition.

Title XV also jeopardizes its own procompetitive objectives by exempting utility-affiliated power producers from PUHCA without prohibiting self-dealing between an exempt wholesale power producer and its affiliated utility. Without a bar against self-dealing, Title XV opens the door to one of the egregious practices that PUHCA was enacted to stop: self-dealing transactions in which an unregulated utility affiliate overcharges the affiliated retail utility and its ratepayers for the benefit of the unregulated holding company and its stockholders. The extreme difficulty of detecting and effectively regulating self-dealing abuses is well documented. If true arm's-length competition is to result from PUHCA reform, Title XV must prohibit self-dealing between exempt wholesale generators and their affiliated utilities.

With the Fair Competition Amendment, Title XV can be expected to lower consumer electricity rates and increase the diversity and security of the Nation's electricity capacity. Increased competition and access to transmission will not compromise the reliability of electricity service. However, without the Fair Competition Amendment, the market discipline of true competition will not emerge and operate to safeguard consumers in the absence of PUHCA's protective requirements.

**TESTIMONY OF KEYS A. CURRY, JR.,  
EXECUTIVE VICE PRESIDENT OF  
DESTEC ENERGY, INC.**

**Before The**

**SUBCOMMITTEE ON SECURITIES OF THE  
COMMITTEE ON BANKING HOUSING AND URBAN AFFAIRS**

**Concerning**

**TITLE XV OF S.1220,  
THE NATIONAL ENERGY SECURITY ACT OF 1991**

**September 17, 1991**

**I. INTRODUCTION**

I am Keys A. Curry, Jr., Executive Vice President of Destec Energy, Inc. On behalf of Destec, it is my pleasure to testify before the Subcommittee on Securities concerning Title XV of The National Energy Security Act of 1991, S.1220. It is my purpose today to recommend to the Subcommittee a simple and targeted Fair Competition Amendment to Title XV. The Fair Competition Amendment is necessary to ensure that reform of the Public Utility Holding Company Act of 1935 (PUHCA) will actually result in a competitive wholesale power market that will no longer require the fully panoply of PUHCA investor and consumer protections that the Securities and Exchange Commission enforces and this Subcommittee oversees. Without the Fair Competition Amendment, Title XV will simply open the door on some of the most harmful consumer and investor abuses that PUHCA was enacted to stop. I have attached to this testimony a copy of the Fair Competition Amendment and a list of its supporters.

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September 17, 1991  
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## II. DESTEC ENERGY, INC.

First let me introduce Destec and explain to you why Destec is vitally interested in ensuring that Title XV achieves a competitive wholesale power market. Destec Energy, Inc. is a leading independent power producer based in Houston, Texas. Destec develops, builds, owns and operates cogeneration facilities that produce and sell electrical and thermal energy, as well as facilities that manufacture synthetic fuel gas for use in energy production. Destec has interests in ten operating power projects with a total rated-capacity of 960 megawatts (MW) of electricity and over two million pounds per hour of steam. Destec also markets for The Dow Chemical Company over 525 MW of cogenerated electricity.

Destec was formed by The Dow Chemical Company, an industrial consumer of energy with a history of more than 90 years generating its own power and steam. Destec has established a premier position in the industry building upon Dow's technical know-how and operating experience. As a long-time leader in the development of innovative energy technologies, Dow has acquired expertise in operating power general plants based on natural gas, coal and alternative energy sources. Dow has made this expertise available to Destec. To further strengthen the Destec position, Dow contributed to Destec its ownership position in Louisiana

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Gasification Technology, Inc., (LGTI), owner of the world's largest integrated coal gasification combined cycle power plant.

In 1989, to strengthen its position in the independent power market, Destec acquired PSE Inc., a company whose roots extend from the earliest days of what has become today's independent power industry. In 1969, Dow became PSE's first customer when PSE began development of the 300-MW Salt Grass facility for Dow in Freeport, Texas, a facility which is still operating today. With expertise in combined cycle cogeneration and heat recovery systems and a reputation for excellence in engineering and project development, PSE has established a significant position in the independent power industry.

In 1989, the Independent Power Report recognized Destec and its affiliates as the nation's largest independent power company. Destec has received numerous awards and commendations, including The Environmental Protection Award from Power Magazine, The Industrial Energy Conservation and Environmental Protection Award, the Innovative Technology Award from the Electric Power Research Institute, The Walter Flowers Achievement Award from the Council on Alternate Fuels, and The Industrial Energy Technology Conference Award.

Destec is committed to being a premier independent energy company, dedicated to supplying retail utilities with competitively-priced electricity from the projects that we develop.

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Consistent with this commitment, we support the Title XV's goal of amending PUHCA to accommodate robust competition in the wholesale electricity market. However, as I will explain, Destec does not believe that Title XV, as reported, will achieve that goal.

### III. OBSTACLES TO A COMPETITIVE WHOLESALE MARKET

The Energy Committee's recognition that PUHCA is an obstacle to competitive wholesale power is only one necessary step in fashioning a legislative vehicle for achieving a competitive wholesale power market. Other necessary steps are identifying and removing other significant obstacles, and isolating which provisions of PUHCA require change, and which do not.

Title XV, as reported, is an incomplete vehicle for achieving competition in the wholesale power market. It fails to go beyond simple recognition that PUHCA is an obstacle. An equally great obstacle to wholesale competition is that would-be competitors cannot compete unless they can get their product to markets. This requires access to the Nation's electricity transmission infrastructure. That infrastructure was built by electric utility companies exercising the State-granted power of eminent domain. The electric utility companies, acting pursuant to State franchises, exercise monopoly control over those transmission lines.

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Electric utilities routinely deny would-be competitors access to available capacity on their transmission systems. Moreover, the would-be competitors have no legal or other recourse inasmuch as a 1978 amendment to the Federal Power Act effectively bars the Federal Energy Regulatory Commission (FERC) from ordering the utilities to provide non-discriminatory access to their transmission lines even if access would promote competition. Although the Federal Power Act (FPA) grants FERC the authority to order utilities to provide transmission services if such an order would be in the public interest, subsection 211(c)(1) of the FPA specifically prohibits FERC from issuing these transmission orders unless such an order "would reasonably preserve existing competitive relationships."<sup>1</sup> Given that increased competition necessarily alters existing competitive relationships, FERC's current authority to order transmission access is illusory. Indeed, FERC has rejected legitimate requests for transmission access on the ground that "subsection 211(c)(1) prohibits the issuance of wheeling orders that have a significant procompetitive effect."<sup>2</sup> If PUHCA reform is to promote competition, and not merely effectuate misguided deregulation, then FERC must be given the authority to order procompetitive wholesale wheeling. That authority, of course, would remain subject to all of the other protections granted utilities under the Federal Power Act, such as ensuring reliability and fair compensation.



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Title XV is also an incomplete vehicle in that it fails to ensure that utilities are not permitted to abuse their monopoly powers. True independent power producers such as Destec -- those not affiliated with franchise electric utilities -- can safely be exempted from PUHCA's investor and consumer protection requirements because they do not have any monopoly power to abuse. Likewise, utility-affiliated power producers selling power in competitive transactions to utilities other than their parent utilities can safely be exempted from PUHCA, provided that there are in place appropriate protections against cross subsidies and collusive arrangements between the parent utility and the purchasing utility. However, no PUHCA exemption should be available to a utility affiliate that sells power to its parent. The seminal premise of exempting certain wholesale producers from PUHCA regulation is that those producers will be disciplined by competition. There is no market discipline to replace competition in self-dealing transactions. Self-dealing transactions are not at arm's length and cannot be effectively regulated or policed. Permitting self-dealing will not serve the pro-competitive purposes of PUHCA reform.

#### IV. FAIR COMPETITION AMENDMENT TO TITLE XV

This Subcommittee has long been concerned with enforcement of PUHCA's consumer and investor protections. Destec submits that

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this Subcommittee should insist on a complete legislative program for achieving a competitive market before its agrees to relax any of those consumer and investor protections. No legislation to reform PUHCA can achieve its procompetitive goal without both: (a) providing competitors an opportunity to obtain non-discriminatory transmission access; and (b) barring self-dealing transactions between electric utilities and their affiliated wholesale power producers.

To aid this Subcommittee and the Senate in developing a truly pro-competitive PUHCA-reform package, Destec has worked with a broad group of independent power producers, consumer groups and environmental interests to fashion the Fair Competition Amendment to Title XV. This Amendment would both remedy FERC's current lack of authority to order pro-competitive transmission access, and would close Title XV's open-door to abusive self-dealing transactions.

The Fair Competition Amendment is both narrow and targeted. On transmission access, the Amendment eliminates the existing bar against FERC ordering transmission access where to do so would alter existing competitive relationships. The underlying premise of PUHCA reform is that the non-competitive status quo should not be preserved. To promote competition, the Amendment would authorize FERC to grant a request for transmission access where, after full notice and opportunity for hearing, FERC determines that

the requested access would be in the bulk power market. The existing requirements for compensation to the trans

On self-dealing, the If a utility wishes to affiliate, it is free to of PUHCA, the exempt utility in the affiliated utility. The fold. First, legislation from eligibility for PU approach; we see no reason operating in markets with second alternative is to to self-deal subject to they may self-deal. targeted: No PUHCA-exempt utility affiliates virtually in the new wholesale power would harm consumers as targeted approach is full Energy's (DOE's) finding technical annex on amending

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In a broadly competitive market, prospective sellers would face many possible buyers; the loss of the option of selling to themselves would not reduce the number of buyers appreciably. Similarly, the prospective buyer's options would be constrained little by not being able to buy from an [affiliate]. Thus it appears that there would be little loss of economic efficiency in banning self-dealing, and it would eliminate a major source of concern about possible adverse impacts upon consumers.

V. DESTEC'S POSITION ON ISSUES RAISED BY SUBCOMMITTEE

Chairman Dodd's invitation to testify identified six issues of Subcommittee interest concerning the expected effects of Title XV. To the extent I can, I will briefly address those issues. I defer to the environmental interests represented on the panel to comment on the environmental impacts of Title XV; let me just note that Destec's electricity generating plants have received numerous environmental awards and we will strive to improve further our impressive environmental record in the future.

A. Impact on Consumer Utility Rates

Irrespective of whether a new class of generators of wholesale power is exempted from the requirements of PUHCA, regulatory authority over all rates for interstate wholesale electricity will remain with the Federal Energy Regulatory Commission, acting under the Federal Power Act. In recent years, the FERC has shown a

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willingness to authorize market-based rates where it has been demonstrated that a wholesale power sales agreement was entered into at arm's length in a competitive procurement process. Historically, however, wholesale power rates have been cost-based and not market-based.

Reduced consumer utility rates could be expected from exempting wholesale generators if, among other things, each of the following were to occur:

- an increase in the number of wholesale generators competing for each wholesale sale to an electric utility;
- potential sellers compete in a market in which no competitor is unfairly advantaged or disadvantaged; and
- potential sellers of power are able to get their product to all potential buyers, with no discriminatory denial of access to essential transmission facilities.

Only the first of these three preconditions to lower consumer rates will be satisfied by Title XV. PUHCA exemption will certainly produce more potential wholesale sellers, at least in the short-term. But Title XV provides no meaningful protection against utilities buying from their affiliated exempt wholesale power producers in non-arm's length transactions. The harm of utility self-dealing on ratepayers and competition is well

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documented in the trade literature,<sup>4</sup> and is aptly captured in the observation of the Michigan Public Service Commission concerning wholesale power transactions between the electric utility, Consumers Power Company, and its wholesale power affiliate, MCV: "[O]ne must wonder whether Consumers has once again negotiated with itself and lost."<sup>5</sup> Nor does Title XV do anything to remedy the status quo under which utilities can and do discriminatorily deny access to monopoly controlled transmission facilities essential to effectuating power sales.

Without safeguards against unfair competition by utility affiliates and assurances of fair transmission access, all that will result from PUHCA reform is more potential and eventually frustrated competitors, with no increase in competition or any appreciable lowering of utility rates. Indeed, unfair competition and exclusion from the transmission grid will drive many independent PUHCA-exempt generators out of business, further concentrating control of electricity generation in the hands of utilities and their affiliates. That concentration, in turn, could reduce competition and result in higher utility consumer rates.

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**B. Impact on Adequacy of Nation's Energy Supply  
to Meet the Increasing Demand for Power in  
this Country**

Non-utility wholesale generators have a history of using a more diversified mix of primary fuels to generate electricity than the electric utility industry. Qualifying facilities (QF's) under the Public Utility Regulatory Policies Act of 1978 (PURPA) and non-utility independent power producers generate or cogenerate power from traditional fuels, such as coal, natural gas and fuel oil, as well as a broad array of renewable sources, such as solar and geothermal, and non-conventional materials, such as waste-to-energy. As I noted in my introduction, Destec is a recognized leader in producing gas from coal. At its LGTI facility, located near Plaquemine, Louisiana, Destec converts coal through a gasification process into a refined grade of synthetic fuel gas for use in advanced gas turbines. The facility has the capacity to convert approximately 2,400 tons of western subbituminous coal into approximately 30 billion BTUs per day of fuel. The facility generates the equivalent of 160 MWs.

To the extent that PUHCA reform not only fosters a new market sector of exempt wholesale generators, but also ensures fair competition and non-discriminatory transmission access, then it is reasonable to expect that the Nation's electricity generating capacity stands to be both expanded and made more secure through diversification of primary fuel sources. However, because Title

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XV, as reported by the Committee on Energy and Natural Resources, does not protect against unfair competition from utility affiliates and does not provide for non-discriminatory transmission access, little significant improvement in the Nation's energy supply to meet future demand is likely to result from enactment of Title XV.

C. Impact on Competitive Environment for  
Generation of Electricity, Availability  
and Reliability of Transmission Access

Since 1978, experience with non-utility power generation under PURPA has demonstrated that generation of wholesale power need not be the exclusive bailiwick of vertically integrated utilities. The potential for competitive power generation has also been enhanced by the increasing insistence of state regulators that their local electric utilities competitively procure their power requirements.

Continued growth of a competitive wholesale power industry, however, inevitably stops at PUHCA's door. Potential developers of competitive non-QF plants, such as Destec, will not undertake those projects because to do so would, in most instances, subject them to the extensive and burdensome PUHCA requirements concerning corporate structure, capitalization, issuance of securities, accounting and reporting. The only alternative to subjecting themselves to these costly and burdensome requirements is resort to convoluted financial and ownership structures -- known as "PUHCA



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pretzels" -- in which ownership and control of the wholesale generating projects are divorced.

Exemption of wholesale generators from PUHCA under Title XV is thus likely to result in an increase in the number of potential developers actually entering the market and bringing new electricity generating plants on line. More potential competitors, however, does not mean more wholesale power competition. Title XV does not remedy the persisting problem that non-utility generators are denied access to essential transmission facilities. Without transmission access, any increase in the number of wholesale generators will not produce a proportionate increase in competition.

You have also inquired into the impact that Title XV is expected to have on the reliability of transmission. The simple answer is that, because Title XV does nothing to remedy the absence of transmission access, it will have no impact on transmission reliability. Let me suggest that the more germane inquiry is whether legislative action to facilitate increased transmission access by exempt wholesale generators will impact transmission reliability. In response to this inquiry, let me first point to the DOE's recently-published National Energy Strategy technical annex entitled "Electricity Transmission Access," which concludes that "given adequate time to adjust, and without a very large increase in the number of entities seeking transmission access,

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there seems to be no reason why increased transmission access should cause decreased reliability."<sup>6</sup> DOE based this conclusion on the analyses performed by both the Office of Technology Assessment (Electric Power Wheeling and Dealing, May 1989) and the Large Public Power Council.<sup>7</sup>

Let me briefly point to the experience of Destec in our home state of Texas. For more than six years the State of Texas has required wholesale wheeling of QF power to utility buyers within the Electric Reliability Council of Texas (ERCOT). Over 1,300 MWs of power is currently being wheeled from the Texas Gulf Coast region, where surplus cogenerated power exists, to Central and North Texas, where additional power is needed. Destec and The Dow Chemical Company account for approximately 600 MWs of this power. Texas has experienced no diminution of system reliability as a result of this required wholesale wheeling. Nor has the introduction of wholesale wheeling led to a trip down the much-ballyhooed "slippery slope" to retail wheeling and stranded investments.

**D. Impact on Regulations that Protect  
 Consumers and Stockholders from Utility  
 Abuse and Conflict of Interest**

One of the most common abuses of the pre-PUHCA holding companies was self-dealing -- transactions between retail utilities and the various affiliated service companies within the same

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holding company system. These transactions were structured to overcharge the operating utilities and overvalue their assets so as to overcharge ratepayers and siphon the resulting profits to the holding company and its limited number of investors. In his March 12, 1935, transmittal letter sending PUHCA to the Congress, President Roosevelt explained:

We seek to establish the sound principle that the utility holding company so long as it is permitted to continue should not profit from dealings with subsidiaries and affiliates where there is no semblance of actual bargaining to get the best value and the best price. If a management company is equipped to offer a genuinely economic management service to the smaller operating utility companies it ought not to own stock in the companies it manages, and its fees ought to be reasonable.

To the extent that affiliated companies within a holding company are permitted to transact business under PUHCA, they are required to do so at the lesser of cost or fair market price.

Utility-affiliated wholesale generators are the modern equivalent of the affiliate companies referred to in President Roosevelt's letter. Under Title XV, they would be exempted from PUHCA, and the only protection provided against abusive self-dealing transactions between a utility and its affiliated PUHCA-exempt power producer is Title XV's directive that:

A rate or charge for the sale of electric energy at wholesale in interstate commerce by an exempt wholesale generator shall not be considered just and reasonable within the meaning of sections 205 and 206 of the Federal

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Power Act . . . if the rate or charge allows the exempt wholesale generator to receive undue advantage resulting from the fact that the purchaser of such electric energy is an affiliate or associate company of such exempt wholesale generator.

In other words, if a utility shows favoritism to its affiliate and gets caught, and if the accuser convinces FERC of the utility's undue affiliate favoritism, then FERC cannot approve the wholesale sale. These protections are too little and too attenuated.

In most instances, as State commissions have found, affiliate favoritism in self-dealing transactions is difficult and expensive to detect, although very costly to ratepayer and would-be competitors. An enlightening example is found in the California Public Utilities Commission's (CPUC's) protracted investigation of a self-dealing wholesale power agreement between Southern California Edison Company and the Kearn River Cogeneration Company, a partnership in which Edison possessed a 50 percent interest. The CPUC found numerous instances of conflict of interest and that, as a result of the self-dealing, California ratepayers were overcharged \$48 million during the three-year period covered by the CPUC investigation. The testimony of the CPUC's Department of Ratepayer Advocate (DRA) speaks eloquently of the inability of even well-staffed regulatory commissions to police self-dealing:

Auditing and assessing the reasonableness for ratepayers of transactions between utilities

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and their corporate relations . . . is monumentally difficult, painful, controversial and litigious. Utility management is often forced to defend sweetheart deals made for the benefit of affiliates or holding company headquarters, thus putting utility management in a very uncomfortable position. The DRA is not equipped to monitor and investigate all possible abuses in utility transactions with affiliates and headquarters.<sup>10</sup>

In short, detection of affiliate favoritism in self-dealing transactions will be the exception to the rule. Title XV will thus offer no protection.

#### VI. CONCLUSION

In closing, let me emphasize that Destec supports pro-competitive reform of PUHCA. With the Amendment that I have discussed, Title XV could become a vehicle for achieving a competitive wholesale power industry. Destec therefore urges the Subcommittee to support this Amendment and urge its adoption to Chairman Johnston, the Members of the Committee on Energy and Natural Resources and your fellow Senators.

On behalf of Destec, and on behalf of the independent power producers, consumer groups and environmental interests that have worked with Destec on the Fair Competition Amendment, I thank you Mr. Chairman and Subcommittee members for this opportunity to testify.

## ENDNOTES

1. 16 U.S.C. § 824j(c)(1).
2. Southeastern Power Admin. v. Kentucky Utils. Co., Op. No. 198-A, 26 FERC ¶ 61,127 at 61,323 (1984). FERC has also determined that "subsection 211(c)(1) prohibits the Commission from using its new wheeling authority to remedy relationships that are unlawful under the antitrust laws . . . ." Southeastern Power Admin. v. Kentucky Utils. Co., Op. No. 198, 25 FERC ¶ 61,204 at 61,538 (1983), reh'g denied in pertinent part, Op. No. 198-A, 26 FERC ¶ 61,127 (1984).
3. U. S. Dept. of Energy, National Energy Strategy Analysis of Options to Amend the Public Utility Holding Company Act of 1935, Technical Annex 1, at 33 (1st ed. 1991/1992).
4. E.g., Bogorad, Self-Dealing: The Case Against Removing PUHCA Restrictions on Utility-Affiliated Power Producers, Jan./Feb. 1991 Elec. J. 45; R.E. Russell, Who Needs PUHCA?, Remarks to the American Bar Association Section of Natural Resources, Energy, and Environmental Law (March 8, 1991). For the convenience of the Subcommittee both the Bogorad article and the remarks of Commission Russell, Michigan Pub. Serv. Comm'n, are attached.
5. Michigan Pub. Serv. Comm'n, Order of June 22, 1989, at 30-31.
6. U.S. Dept. of Energy, National Energy Strategy Electricity Transmission Access, Technical Annex 3, at 18 (1st ed. 1991/1992).
7. Id.
8. Letter from President Franklin D. Roosevelt to 74th Congress 2 (March 12, 1935).
9. S. 1220, 102nd Cong., 1st Sess., § 15105.
10. Report on the Reasonableness of Southern California Edison Non-standard Power Purchase Contracts with Qualifying Facilities, prepared by the Staffs of the Energy Resources Branch and the Energy Auditing Branch of the DRA, submitted in CPUC Application No. 88-02-016, at IV-30 (Dec. 1988).

**FAIR COMPETITION AMENDMENT TO  
TITLE XV OF S. 1220,  
THE NATIONAL ENERGY STRATEGY ACT OF 1991**

**1. TRANSMISSION ACCESS TO PROMOTE COMPETITION**

Add the following section after Section 15108:

**Sec. 15109      FERC AUTHORITY TO PROMOTE COMPETITION THROUGH  
WHEELING ORDERS**

(a) Subsection 211(c) of the Federal Power Act (16 U.S.C. 824j(c)) is amended by striking paragraph (1) and redesignating paragraphs (2), (3), and (4) as paragraphs (1), (2) and (3) respectively.

(b) Subsection 211(a) of the Federal Power Act (16 U.S.C. 824j(a)) is amended by inserting after subparagraph (2)(A) the following "(B) increase the potential for competition in wholesale electricity markets," and redesignating subparagraphs (B) and (C) as subparagraphs (C) and (D) respectively. Subsection 211(a) is further amended by striking "geothermal power producer (including a producer which is not an electric utility)," in the first sentence and substituting "other person generating electric energy for sale for resale," and by striking "may" in the second sentence and substituting "shall".

**2. PROHIBITION OF SELF-DEALING**

Section 15103 is amended by changing subsection "(a)" to "(1)" and subsection "(b)" to "(2)", and by inserting into the first sentence of the section, between the phrase "wholesale generator" and the word "if," the following:

"(a) if any part of that electric energy is, at any time, sold to any person that is, or is an affiliate or associate company of, a public-utility company or holding company that is an affiliate or associate company of such exempt wholesale generator; or (b)"

\*\*\*\*\*

**ENDORSEMENTS OF  
FAIR COMPETITION AMENDMENT TO  
TITLE XV OF S.1220**

**I. Organizations and Associations**

American Iron & Steel Institute  
 American Public Power Association  
 American Paper Institute  
 American Wind Energy Association  
 Chemical Manufacturers of America  
 Consumer Federation of America  
 Council of Industrial Boiler Owners (CIBO)  
 Electricity Consumers Resource Council (ELCON)  
 Environmental Action  
 Independent Energy Producers (IEP)  
 Michigan Municipal Cooperatives Group  
 Michigan Municipal Electric Association  
 Union of Concerned Scientists

**II. Companies and Other Entities**

Applied Energy Services (AES)  
 California Energy Company  
 Destec Energy, Inc.  
 Dow Chemical Company  
 Energy Michigan, Inc.  
 Florida Municipal Power Agency  
 Geneva Steel Corporation  
 Hadson Power Systems  
 Kenetech Corporation  
 Mordic Power, Inc.  
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## Self-Dealing: The Case Against Removing PUHCA Restrictions on Utility-Affiliated Power Producers

*Utilities have shown how they can use affiliated power suppliers to create shareholder gains and ratepayer losses. Their opportunities should be restricted, not expanded.*

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Amendments to the Public Utility Holding Company Act (PUHCA) of 1935 are being proposed to eliminate restrictions on electric utilities' forming affiliated nonutility power companies within a holding company structure.

By enacting PUHCA, Congress imposed restrictions to protect investors, consumers, and the public from further financial abuses by highly leveraged and concentrated utilities.<sup>1</sup> These abusive practices, including non-arm's-length contracts within a holding company group that permitted the "milking" of electric and gas

utilities (and their customers) by parent holding companies, were thought by Congress to be a major cause of the stock market crash of 1929 and the ensuing Great Depression.

Legislation proposed in the 101st Congress by Senator Bennett Johnston (D-La.)<sup>2</sup> would undo much of PUHCA's protection in the name of competition and efficiency. Under the Johnston bill, so-called "independent power producers," including affiliates of major electric utilities, would be permitted to construct and operate generation which is not "integrated" with their affli-

sted utilities and to avoid all other safeguards of PUHCA.

**T**he bill appears to be premised on the assumption that independent power producers, operating in a competitive environment, will produce better results than utilities, operating under traditional regulation. Such utilities brought us Marble Hill, Grand Gulf, Shoreham, Seabrook, etc. — nuclear plants which either came in vastly over budget or were never completed. Yet, the bill would foster plant construction by affiliates of these same utilities, on the apparent assumption that they know best how to construct generation.

The proposed legislation, moreover, simply assumes the existence of a competitive market with discipline sufficient to substitute for the regulatory control mechanism. Nothing in the bill would assure transmission access needed to permit a large enough number of prospective buyers and sellers to interact to establish an effective market. The bill, if enacted, would permit the utilities to "wheel and deal" for their own benefit without being actually required to wheel for or deal with anyone other than their own affiliates.

**A**ny potential savings from the hoped-for competitive market may be more than offset by excessive costs imposed by the increased opportunity for harmful self-dealing. Within a holding company, there is a strong incentive for the nonutility affiliate to overcharge the regulated utility for power. In this way, the hold-

ing company can earn more than the utility's approved rate of return. The incentive is similarly strong to underprice resources transferred from the regulated to the nonutility affiliate. Either way, the costs charged the utility's customers are inflated.

Before we jump head first into the "PUHCA-less" world of the Johnston bill, it makes sense to glean information about what the world might be like if, as pro-

onstrates the need both for a harder look at the assumed benefits of eliminating PUHCA restrictions and for protections to redress the likely abuses.

**B**efore looking at some case studies, we briefly explore the existing regulatory apparatus to provide a context for the examples and the current debate. This survey highlights the role of PUHCA in restricting the opportunity for harmful self-dealing, and the current limits on regulation of power transactions among affiliates. In light of the regulatory framework, it is no surprise that the case studies tend to arise in the PURPA context. Under PURPA, a utility-affiliated QF can be created, financed and acquired, and can sell power to its affiliated utility at the utility's avoided cost (rather than the selling affiliate's cost) with no PUHCA review and limited state regulation.

These same conditions could apply to all nonutility affiliates if the Johnston bill is enacted so that any utility could create a power supply affiliate free from PUHCA regulation. Particularly if the Federal Energy Regulatory Commission (FERC) continues its current course toward market-based rates, the invitation for utilities to engage in harmful self-dealing with nonutility affiliates may prove irresistible. State regulation, as limited by the doctrine of federal preemption, may prove insufficient to ferret out and remedy such abuses.

Thus, the existing regulatory scheme sets the backdrop for the case studies and demonstrates

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posed, utilities were relieved of existing restrictions on their ownership and control of nonutility generators. A glimpse into such a future is at hand, in the form of experience with nonutility affiliates of regulated utilities and under the Public Utility Regulatory Policies Act (PURPA) with partial utility ownership of qualifying facilities (QFs). This experience, which might well become the norm if the Johnston bill is enacted, dem-

why abusive self-dealing could become widespread if the Johnston bill is enacted.

### I. Existing Framework for Regulating Utility-Affiliate Transactions

#### A. PUHCA

The Public Utility Holding Company Act, which structurally limits the avenues for abuse, is the first line of defense against a utility's use of affiliates to harm consumers and competitors.<sup>3</sup>

PUHCA requires preacquisition review by the Securities and Exchange Commission (SEC) of any utility acquisition by a registered holding company<sup>4</sup> or any other person where the acquirer is, or as a result of the acquisition will be, an owner of five percent or more of two or more public utilities.<sup>5</sup> Among other things, the acquisition must serve the public interest by tending toward the economical and efficient development of an integrated public utility system and must not be detrimental to the public interest, the interest of investors or consumers, or the proper functioning of the holding company system.<sup>6</sup>

PUHCA also provides for ongoing review of the financial activities of registered holding companies, limits their investments in unrelated enterprises and prohibits certain inter-affiliate transactions unless certain requirements are met.<sup>7</sup>

PUHCA provides for exemption of holding companies from some provisions of the Act in certain circumstances (which largely confine the holding company sys-

tem to a single state) unless it is detrimental to the public interest or the interest of investors and consumers.<sup>8</sup> Nevertheless, even an exempt holding company must comply with PUHCA's pre-acquisition review requirements.<sup>9</sup>

While some PUHCA safeguards have been weakened by the manner in which they have been interpreted by the SEC,<sup>10</sup> if they are enforced they have the potential to protect consumers and promote competition.<sup>11</sup> The Johnston bill would remove that protection.

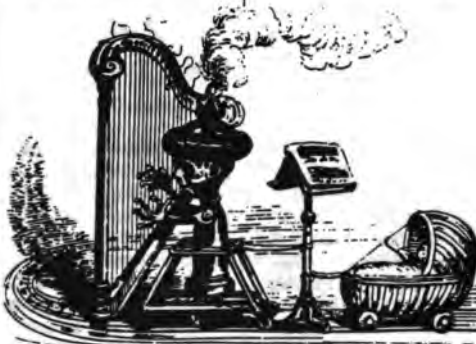
#### B. State and Federal Rate Regulation

Once the PUHCA barrier is surmounted (or avoided under the Johnston bill) and the generation affiliate is formed, state and federal rate regulation come into play, but it is not always clear who has the ball. A utility's wholesale power transactions with its affiliates are regulated by FERC.<sup>12</sup> Under *Nantahala Power &*

*Light Co. v. Thornburg*,<sup>13</sup> state commissions are generally preempted from disallowing in a utility's retail rates the price paid by that utility for electricity purchased pursuant to a FERC-regulated electric rate.

However, under the *Pike County* doctrine,<sup>14</sup> states may be able to examine the prudence of the purchase outside the context of an allocation of power costs among affiliated utilities by means of a FERC-jurisdictional bulk power arrangement.<sup>15</sup> Even in that context, a state disallowance may be permissible if based on the utility's failure to take prudent steps to mitigate losses resulting from the FERC-approved purchase.<sup>16</sup> The *Pike County* doctrine, however, has not been expressly adopted by the Supreme Court.<sup>17</sup>

To the extent regulation moves from the state to the federal arena, how FERC would exercise its jurisdiction is unclear. FERC has



*Utility affiliates say they could make beautiful music, if they were just allowed.*

been experimenting on an ad hoc basis with what it terms "market-based rates." FERC has agreed to relax its traditional cost-based rate regulation "where the seller can demonstrate that it lacks market power over the buyer"<sup>18</sup> or has adequately mitigated such power.<sup>19</sup> Recently, FERC appears to have dispensed with the avoided cost cap it had earlier required,<sup>20</sup> even where the transaction does not directly result from state-approved bidding procedures.<sup>21</sup> Unfortunately, FERC has offered no consistent, defensible view on when a market is competitive.

In regulating wholesale transactions in this way, FERC is applying pricing standards similar to (but more flexible than) those authorized by Congress to encourage cogeneration and small power production.

In approving market-based pricing, FERC has relied on the absence of affiliation with a utility to find a lack of market power and inability to engage in self-dealing.<sup>22</sup> The potential for self-dealing has been the basis for FERC's rejection of several attempts at market-based rates by utility affiliates.<sup>23</sup> Nevertheless, FERC has approved market-oriented prices to affiliated purchasers where the sale was on the same terms at which the power was sold to an unaffiliated utility and which state regulatory had found to provide savings for consumers.<sup>24</sup>

In one recent case, FERC accepted (with one modification) rates for transactions involving affiliates as justified under cost-of-service principles, while refusing

to accept those rates under its market-based approach.<sup>25</sup> FERC commented that concerns about preferential pricing could be eliminated by relying on "market tests" for inter-affiliate transactions so long as the "market price" is not less than the variable cost of providing service, and the utility has not "narrowed the market" to validate a low transfer price.<sup>26</sup> Particularly where lack of transmission access results in a



less competitive market than the Commission appears to assume, this "market test" may prove insufficient protection against ratepayer subsidization of affiliates by bearing a disproportionate share of fixed costs.

FERC has probed only superficially for evidence of reciprocal self-dealing.<sup>27</sup>

While FERC's stated intent to closely scrutinize affiliate transactions<sup>28</sup> accords with its statutory mandate to protect consumers, FERC's limited experience to date with these "market pricing" schemes leaves unclear where FERC may draw the line between permissible and impermissible behavior

by affiliated power producers.

### C. PURPA

PURPA provides an avenue for an affiliate to sell power to its sister regulated utility at avoided cost and without regard to FURCA's protections. Under PURPA,<sup>29</sup> as implemented by FERC, certain qualifying cogeneration and small power producers are exempt from FERC wholesale rate regulation.<sup>30</sup> In addition, QFs are exempt from state rate regulation (except for the implementation of FERC's rules requiring utility purchases from QFs at rates not exceeding the utility's avoided cost),<sup>31</sup> FURCA, and state financial and organizational regulation of utilities.<sup>32</sup>

FERC has implemented PURPA's requirement that QFs shall not be owned by a person primarily engaged in the generation or sale of power<sup>33</sup> by permitting electric utilities to hold up to 50 percent of the equity in the facility.<sup>34</sup> In applying this standard, FERC has looked narrowly to whether the 50% ownership test is met on the date when the facility produces energy,<sup>35</sup> thus permitting a utility to maintain a greater share of ownership and control during the pre-operation period when the power sale contracts and critical ownership and participation arrangements are structured. In addition, although FERC has explained that control as well as the distribution of the "stream of benefits" are decisive factors in determining percentage of ownership, FERC has refused to recognize as an ownership in-

terest a debt whose principal varies according to the profitability of the QF.<sup>3</sup>

In this way, PURPA permits utilities to establish "independent power" affiliates under a holding company structure while avoiding regulation as a holding company. Experience under PURPA provides a window on what the world might be like if PUHCA restrictions were lifted. The case studies described below (two in PURPA situations, one outside the PURPA context) illustrate the threat to consumers and competitors where a nonutility generator engages in power transactions with its regulated affiliate.

## II. Case Studies

### A. Consumers Power Company

The recent history of Consumers Power Company and its affiliates reveals the dangers of non-arm's-length transactions and impairment of state regulatory authority that PUHCA was designed to combat.

In the early 1970s, Consumers Power began construction of a nuclear power plant in Midland, Michigan. After it experienced a number of problems, Consumers Power cancelled the plant in July 1984.

Cancellation of the Midland plant created severe financial difficulties for Consumers Power, which had invested some \$4.2 billion in the facility. In 1985, the Michigan Public Service Commission (MPSC) took what it has termed the extraordinary and unprecedented step of authorizing a six year rate increase of \$99 mil-

lion per year that was designed to provide additional cash flow to help Consumers Power avoid bankruptcy and financially stabilize the company. The MPSC has said that the increase was not based upon cost-of-service ratemaking principles.<sup>7</sup>

In 1987, a holding company (CMS Energy Corporation) was

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formed. Consumers Power became a subsidiary of CMS Energy. Consumers Power transferred approximately \$1.5 billion of booked abandoned nuclear plant assets to its affiliate Midland Cogeneration Venture (MCV). MCV converted the plant into a gas-fired cogeneration facility, intended to supply steam to Dow Chemical Company and electricity to Consumers Power as a PURPA qualifying facility.<sup>8</sup>

While it owned more than 30% of MCV through subsidiaries,<sup>9</sup> Consumers Power signed a 35-year contract with

MCV. According to the MPSC, this contract requires Consumers Power to purchase 1,240 MW of MCV capacity.<sup>10</sup>

In September 1987, MCV filed an application with the MPSC for approval of the contract's capacity charges. The MPSC ordered a determination of the avoided costs on Consumers Power's system and the appropriate mix of suppliers to meet its projected need for capacity.

The MPSC has termed the Consumers Power proceeding "among the most complex, most controversial, and most highly contested proceedings ever heard by the Commission."<sup>11</sup> The pre-hearing conferences and hearings required 90 days. More than 60 parties participated, and more than 100 witnesses testified. The record consists of 14,383 pages of transcript and 428 exhibits.<sup>12</sup>

On January 31, 1989, the MPSC issued an Opinion and Interim Order which set the firm capacity need of Consumers Power from cogeneration and small power production projects at 1,160 MW. The Commission directed Consumers Power to contract with a variety of projects offering firm commitments, fuel diversity, reliability, and prices at or below the determined avoided cost. The Commission required that no more than 55% of the capacity be obtained from any one project and no more than 75% of the capacity be supplied by projects using any one fuel. These restrictions meant that Consumers Power could purchase no more than 638 MW from the MCV proj-

ent, as a capacity inter-lease than that provided in its contract."<sup>41</sup>

Consumers Power requested that the MFSC initiate order by submitting a package of power purchase agreements for 1160 MW of capacity including 610 MW from MCV.<sup>42</sup> Consumers Power requested approval to purchase an additional 250 MW from MCV. By Order of June 21, 1989, the MFSC refused to approve the purchase of more than 610 MW from MCV but provided for the execution and filing of contracts which met the requirements of its order.<sup>43</sup>

Consumers Power did not comply with the June 21, 1989 order. Instead, it notified the MFSC that it had terminated commitments to develop with assigned contracts and stated its intention to honor only its previously signed contracts with MCV and fore other developers.<sup>44</sup> On September 26, 1989, the MFSC ordered rehearing in light of Consumers Power's failure to comply. In its Opinion and Order of December 21, 1989, the MFSC maintained the 1160 MW capacity cap but eliminated the requirement that only 35% of the capacity be supplied by a single project,<sup>45</sup> thus allowing Consumers Power to use 840 MW of MCV.<sup>46</sup>

The MFSC has found financial and corporate dealings with respect to Midland/MCV to raise a variety of serious problems, some of which are outlined below. In numerous legal actions, Consumers Power has challenged various MFSC rulings and contractual and legal grounds.

**1. Lack of Arm's-Length Bargaining.** In its January 31, 1989 Opinion and Interim Order, the Michigan Commission concluded that "the record establishes that the Consumers/MCV contract did not result from arm's-length negotiations."<sup>47</sup> The MFSC found that MCV's chief negotiator was selected by a vice-president of

one to Consumers Power's efforts to renegotiate the MCV contract: "One must wonder whether Consumers has once again negotiated with itself and lost."<sup>48</sup>

In connection with the complicated inter-affiliate transactions pertaining to disposition of the proceeds of the Midland assets, the MFSC found a lack of arm's-length bargaining and a blurring of corporate identities within the CMS family of companies.<sup>49</sup> The Commission concluded: "If no corporate renegotiation of Consumers had taken place, and if arm's-length bargaining had occurred, it is unlikely that Consumers would have accepted the debenture that has been provided in this case to its subsidiary."<sup>50</sup>

## 2. Risks to Ratepayers.

The MFSC found that Consumers Power's "corporate policy that pursue maximum MCV capacity as its highest priority" entails risk to ratepayers. The MFSC noted, in connection with Consumers Power's May 1989 request for approval of an additional 250 MW of MCV capacity above and beyond the 1160 MW firm capacity need set by the MFSC:

"[T]he company's proposal is not without significant risks that ratepayers will pay for the 250 MW of additional MCV capacity, regardless of whether there are reasonable opportunities to avoid the need for that capacity. Consumers' activities to date with regard to the MCV provide no basis to believe that the company will not seek additional ways to promote the interests of

## *The Michigan PSC: "The record establishes that the Consumers/MCV contract did not result from arm's-length negotiations."*

Consumers Power and, during the negotiations on behalf of MCV, reported to a Consumers Power vice president and was paid by Consumers Power.<sup>51</sup> The MFSC concluded that "Consumers had a dominant, controlling role in the MCV at the time of the contract negotiations."<sup>52</sup>

The MFSC further observed that "unlike most arm's-length transactions, Consumers and the MCV share a commonality of interest. Specifically, both Consumers' shareholders and the MCV partners benefit from higher capacity rates and lenient contract provisions."<sup>53</sup>

The MFSC commented, in refer-

the MCV, and thereby Consumers' stockholders at the expense of its ratepayers.<sup>57</sup>

The MPSC further observed:

One can only speculate whether the company would be as eager to put itself "at risk" for the additional 250 MW of MCV capacity if it did not own a substantial interest in the MCV.<sup>58</sup>

The Commission also found that the MCV contract provided MCV with too much latitude regarding the amount of capacity it would supply (thus precluding Consumers Power from relying on receipt of a specified amount of MCV capacity), and appeared "overly beneficial to the project with respect to how capacity and energy payments are ultimately calculated."<sup>59</sup>

Finally, the MPSC noted the risk to ratepayers due to Consumers Power's significant financial exposure under its contract with MCV:

It is . . . disingenuous for the company to claim that its customers are not at risk under a contract that requires Consumers to pay for electricity from the MCV whether there is a market for it or not.<sup>60</sup>

The MPSC concluded: "[T]he needs of Consumers' ratepayers have taken a back seat to the needs of the MCV."<sup>61</sup>

**3. Adverse Effects on Competition.** Pursuant to the MPSC's January 31, 1989 Opinion and Interim Order, Consumers Power renewed negotiations with power producers. According to the MPSC, Consumers Power required each project to pay a fee of

\$10,000 to participate in the negotiation process; and it would not allow developers to increase the size of their original projects even though the pricing scheme set by the MPSC made some projects uneconomical.<sup>62</sup>

As described by the MPSC, many developers complained that "the combination of the rates and terms of the agreements made them the most onerous power



purchase agreements in the United States."<sup>63</sup> One said that "the standard agreements contain virtually every 'deal-breaker' Consumers could think of to prevent developers from obtaining financing."<sup>64</sup>

The MPSC noted "the regrettable implication that Consumers' self-dealing is responsible for some of the shortcomings in the [negotiation] process."<sup>65</sup>

While not ruling on the issue, the MPSC noted that Consumers Power had offered MCV transmission access but had been

unwilling to provide the same access to other buyers and sellers of electricity.<sup>66</sup>

**4. Ratepayer Subsidization of MCV Gas Costs.** Consumers Power, a combined gas and electric utility, sells both natural gas and electricity to its customers. In a recent order regarding Consumers Power's gas cost recovery plan, the MPSC found that in its negotiations on behalf of itself and MCV for long-term contracts with the gas producers, Consumers Power had used its utility gas contracts to subsidize MCV's gas costs. The MPSC found:

First, . . . the [gas] contracts signed by Consumers and the MCV with each of the ten producers were negotiated as a package deal. . . .

Second, . . . certain beneficial aspects of MCV's gas purchase contracts were likely obtained at the expense of Consumers' sales customers. . . .

Third, . . . particularly in later years, the pricing provisions negotiated on behalf of the MCV may prove superior to those received by Consumers.<sup>67</sup>

The MPSC disallowed \$3.7 million of these costs, half the projected cost differential between the MCV and Consumers Power contracts. This remedy was based on the premise that in "negotiating each pair of contracts as a package deal, Consumers agreed to pay more than the asking price in exchange for a below-the-asking price rate for the MCV," resulting in a prudent market price at the midpoint between each parallel contract.<sup>68</sup>

**5. Impairment of State Regulation and Consumers Power's Financial Well-Being.** As evidenced by Consumers Power's refusal to comply with the MPSC's January 31 and June 22, 1989 orders with respect to contracts between Consumers Power and MCV and other qualifying facilities, the MCV situation has put Consumers Power at odds with the MPSC. As observed by the MPSC:

Consumers has decided to purchase more capacity than the Commission found to be needed and will purchase almost all of that capacity from a single, natural gas-fired project in which Consumers has a substantial ownership interest. . . . Consumers' decision to contract with its own project for the bulk of the capacity it will purchase and to challenge the Commission's authority to require a diverse mix of qualifying facilities will leave the state without a reasonable cogeneration policy for Consumers' service territory, [and] will not allow the development of many small qualifying facilities. . . .<sup>69</sup>

More recently, the Michigan Commission found that Consumers Power created various affiliated corporate entities to evade regulation. At issue was Consumers Power's compliance with the conditions for receipt of its extraordinary non-cost based, financial stabilization rate increase, pursuant to the MPSC's March 29, 1985 order. According to the MPSC, Condition 11 of that order required Consumers Power to submit to MPSC jurisdiction with regard to the use of proceeds from

the sale of the Midland nuclear plant assets.<sup>70</sup> This condition was designed to assure that the Midland proceeds are used to improve Consumers Power's financial health, which was impaired by its \$4.2 billion Midland-related investment.<sup>71</sup> The Commission found that, rather than comply with this condition, Consumers Power and its parent have taken steps to keep the Midland pro-



ceeds out of the hands of Consumers Power and the regulatory control of the MPSC.<sup>72</sup>

As described by the MPSC, in 1987, Consumers Power transferred the Midland plant assets for use in the MCV project to two subsidiaries at a book value of about \$1.5 billion. On March 12, 1990, these subsidiaries transferred the Midland assets to MCV in exchange for a 49% equity interest in MCV and rights to \$1.2 billion of marketable MCV notes.<sup>73</sup> On the same day, the stock of those Consumers Power subsidiaries was transferred to its parent,

CMS Energy, in exchange for \$1.4 billion of CMS Energy debentures which are "essentially . . . non-marketable," and the value of which largely depends on the dividends Consumers Power pays to its parent.<sup>74</sup>

The MPSC found: "[T]he transactions among Consumers, CMS Energy, and their affiliates . . . constitute an attempt to evade the requirements of condition 11 . . .<sup>75</sup> and sacrifice the financial health of the utility operations to the nonutility enterprises:

Instead of using its resources to return the company to financial health, the company's management has pursued all conceivable legal and regulatory avenues to separate the benefits of improved financial health from the utility and to transfer them to the parent holding company, where they can be used in whatever way these managers see fit, even though Consumers has not yet achieved financial health and faces many near-term uncertainties that prudent managers would not ignore. What has developed is a concerted effort to prevent the utility from obtaining the cash to meet its obligations and prepare for contingencies and, instead, to use cash from Midland plant assets for non-utility enterprises.<sup>76</sup>

This complex matter is now before the Michigan courts,<sup>77</sup> where Consumers Power argues, among other things, that the MPSC lacks jurisdiction over the nonutility subsidiaries of CMS Energy and is limited by, among other things, federal preemption.<sup>78</sup>



### B. Southern California Edison

Another example of the threat to consumers and competitors posed by nonutility generators that transact with their affiliated utility can be seen in Southern California Edison Company's contract with an affiliated QF, as described by the California Public Utilities Commission (CPUC).

On January 16, 1984, Edison entered into a Parallel Generation Agreement with the Kern River Cogeneration Company (KRCC), a 50/50 partnership between Getty Energy Company (now part of Texaco Producing, Inc.) and Southern Sierra Energy Company (Southern Sierra or SSEC). At that time, Southern Sierra was a wholly-owned subsidiary of Edison.

In 1988, Edison reorganized under the holding company SCEcorp with two separate, wholly-owned subsidiaries: Edison, the regulated utility, and the Mission Group, the nonutility subsidiary. Southern Sierra was made a subsidiary of Mission Energy Company, which in turn is a subsidiary of the Mission Group.<sup>69</sup>

The KRCC contract was the subject of an extensive investigation by the CPUC's Department of Ratepayer Advocates (DRA).<sup>70</sup> The CPUC's recent decision regarding the reasonableness of the KRCC contract<sup>71</sup> highlights many of the same concerns raised in the Michigan proceedings. Edison and KRCC have applied to the CPUC for rehearing of the decision.

**1. Lack of Arm's-Length Bargaining.** The CPUC concluded

that "certain actions taken by Edison have reflected a disregard for the appearance of self-dealing and, in some instances, have resulted in placing KRCC's interests ahead of those of its ratepayers."<sup>72</sup>

The CPUC found that most of the Edison personnel responsible for negotiating and executing the 170 MW contract with KRCC<sup>73</sup> were at the same time officers or employees of Southern Sierra or KRCC. The attorney responsible for reviewing the KRCC contract at Edison served as an officer of Southern Sierra; the Edison vice president responsible for the KRCC contract on Edison's behalf was then President of Southern Sierra; the manager responsible for negotiating the KRCC contract on behalf of Edison served as vice president and general manager of Southern Sierra and was the lead of two Southern Sierra representatives on the four-person KRCC Management Com-

mittee.<sup>74</sup>

According to the CPUC, Edison and KRCC saw no conflict of interest. Although Southern Sierra members were present when the KRCC contract was discussed by the KRCC Management Committee, the Southern Sierra members could not vote on the KRCC contract.<sup>75</sup> Edison's vice president testified that Edison managers were verbally directed to protect Edison's ratepayers and not to accord special consideration to affiliates.<sup>76</sup> An Edison employee serving as one of Southern Sierra's representatives on the KRCC Management Committee was verbally directed to act at all times to advance the interests of Edison and its ratepayers.<sup>77</sup>

Edison's precautions were found to be insufficient: the CPUC found the DRA's self-dealing concerns to be legitimate.<sup>78</sup>

... Edison personnel had the opportunity to serve and hold simultaneously fiduciary rela-



*The California Public Utilities Commission has taken sharp exception to Southern California Edison's dealings with its affiliates.*

tionships to two very different and conflicting interests. On the one hand, these individuals were to negotiate a contract on behalf of Edison's ratepayers; on the other, as officers of SEEC, each held an obligation to partners: the interests of that company.

[E]ven without a vote on the approval of the contract for SEEC, [one official] seemed to be truly involved on both sides of the bargaining table.

... [H]e was present at all KRCC management committee meetings at which the contract was discussed and, during the same time period, in his office at Edison, provided advice and direction on the agreement to Edison employees.<sup>42</sup>

**2. Risks to Ratepayers.** In 1982, the CPUC approved "standard offer" contracts which the Commission viewed as *par* or reasonable arrangements for purchasing power from QFs. The CPUC allowed utilities to negotiate "non-standard" contracts, but payments under such contracts were to be recovered only upon a showing of reasonableness; non-standard contracts were to be measured against standard offers to determine if they were their economic equivalent. Ratepayers were to receive some compensatory benefit for any increased risks incurred, so as to be indifferent to or even to prefer the non-standard contract over the standard offer.<sup>43</sup>

The KRCC contract is a non-standard contract. The CPUC concluded:

[T]he KRCC contract was not the economic equivalent of a firm capacity standard offer. The terms of this agreement were not designed to ensure a firm capacity commitment, to maintain ratepayer indifference, to shield ratepayers from risks greater than those incurred under a firm capacity standard offer, or to provide ratepayers with significant compensating benefits in exchange for those risks.<sup>44</sup>



Specifically, the increased benefits to KRCC and increased risks incurred by Edison's ratepayers were found to include:

**Unreasonable energy charges:** Edison agreed to pay KRCC "energy prices based on a formula at odds with the standard offers and creating the potential for costs above avoided costs in the later years. . . ."<sup>45</sup>

**Excessive capacity charges:** Edison agreed to pay KRCC the higher price applicable to firm capacity commencing operation during 1986, rather than the lower price applicable to projects commencing operation in 1985, even

though the project was planned to and did commence operation in 1985.<sup>46</sup>

**Termination and maintenance provisions which failed to ensure a firm capacity commitment:** The KRCC contract "contained maintenance and termination provisions without restrictions and repayment provisions comparable to a 20-year firm capacity standard offer."<sup>47</sup> After twelve years, KRCC could terminate on 90 days' notice if, in its opinion, the contract became "unprofitable at any time," without any obligation to refund overpayments due to the contract's front-loaded capacity charges based on a twenty-year commitment.<sup>48</sup> The contract "contained no limit on scheduled maintenance during peak periods and permitted KRCC to schedule maintenance during peak months upon KRCC's determination that it was not practicable to perform maintenance at another time."<sup>49</sup>

The CPUC found that the termination and maintenance provisions increased ratepayer risks, negated the firmness of the contract and transformed it into an "as available" contract.<sup>50</sup>

The CPUC concluded: "Edison acted imprudently in the negotiation and execution of the KRCC contract," noting "the many significant contract terms which placed Edison's ratepayers at greater risk than those contained in Standard Offers. . . ." To remedy this imprudence, the Commission disallowed amounts in excess of charges that would have been incurred under the standard offer for as-available power: \$48

million for the three-year period that was the subject of the proceeding.<sup>109</sup>

**3. Administration of the Contract to the Detriment of Edison's Ratepayers.** The CPUC found that Edison had granted KRCC bonuses when its performance did not meet the contractual standards. Edison allowed KRCC to treat as scheduled maintenance an outage which did not comply with contractual scheduled maintenance procedures. Although the facility only generated power during August and September, Edison gave KRCC the bonus for achievement of an 85% capacity factor from June through September. The CPUC found Edison imprudent in administering its contract with its affiliate.<sup>110</sup>

**4. Adverse Effect on Competition.** According to the CPUC, although Edison contended that it had never refused terms similar to the KRCC contract to other QFs, Edison had not made known to other QFs that such terms were available.<sup>111</sup> Nor was there evidence that Edison had administered bonus provisions with other QFs in the lenient manner in which it administered the KRCC contract.<sup>112</sup>

The DRA also contended that Edison favored affiliates when, at the end of 1984, Edison requested that the CPUC suspend its standard offers due to overcapacity while still negotiating and executing non-standard agreements with affiliated QFs. Although the CPUC found the ev-

idence insufficient to establish that this conduct was "specifically designed to favor its affiliated QFs over nonaffiliated QFs," this issue was left open for further proceedings.<sup>113</sup>

### **5. Impairment of State Regulation.**

In the KRCC proceeding, the DRA recommended that the Commission (1) prohibit Edison from



entering into any new purchase power agreements with QF affiliates, and (2) request the holding company to divest itself of any ownership interest in the QFs with which Edison now does business. The DRA requested this relief because "[t]his is the only way to prevent further self-dealing and serious harm to Edison's ratepayers from affiliated QF transactions."<sup>114</sup> The DRA witness explained:

Auditing and assessing the reasonableness for ratepayers of transactions between utilities and their corporate relations . . . is monumentally difficult, painful, controversial and litigious. Utility management is often forced to defend sweetheart deals made for the

benefit of affiliates or holding company headquarters, thus putting utility management in a very uncomfortable position. *The DRA Staff is not equipped to monitor and investigate all possible abuses in utility transactions with affiliates and headquarters.*<sup>115</sup>

In responding to the DRA's request for relief, Edison argued (among other things) that as a result of federal preemption the CPUC lacks authority to restrict Edison's dealings with and ownership of QF affiliates.<sup>116</sup>

In the KRCC proceeding, the CPUC did not adopt these DRA-proposed remedies. Instead, it ordered Edison, in dealing with projects in which it has an interest, either directly or through affiliates, to adhere to the standard offers or to submit non-standard contracts for CPUC approval before they take effect.<sup>117</sup>

Edison's transactions with affiliates are at issue in its ongoing proceedings at FERC and the CPUC regarding the proposed merger of Edison and SDG&E.<sup>118</sup> The U.S. Department of Justice expressed concerns about the potential for "evasion of rate regulation" because some of the merged company's power needs in the SDG&E area could be met by purchases from Mission Energy.<sup>119</sup>

These "affiliate transactions" entail a risk that Mission Energy may overcharge the regulated utility (the merged company) for power in order to capture supra-normal profits outside the rate-of-return umbrella. The overcharge could be passed on to consumers in the form of increased rates and, potentially,

result in an inefficient resource mix. . . . SCE has contested the CPUC's jurisdiction to regulate these transactions.<sup>110</sup>

The FERC administrative law judge's Initial Decision, which concludes that FERC should reject the merger, includes findings that "the merger will exacerbate the existing potential for self-dealing or other affiliate abuses" (e.g., opportunities for "preferential transmission access to out-of-area Mission Energy projects").<sup>111</sup> The Initial Decision further finds that the CPUC's competitive bidding process will not prevent such affiliate abuses and that some market power abuses "are not susceptible to complete resolution by even the most resolute regulators."<sup>112</sup>

#### C. Tucson Electric Power Company

The third example of the threat to consumers from affiliated power producers arises outside the PURPA context. The Tucson Electric Power Company (TEP) arrangement with Alamito Company illustrates the more generic situation of transfer and buyback (or sale-leaseback) of existing utility generation in a manner that disadvantages utility consumers.

In the early 1980s, TEP had excess generating capacity. In 1983, TEP received the approval of the Arizona Corporation Commission (ACC) to transfer two generating units to Alamito, a wholly-owned subsidiary. TEP's stated purpose was to separate TEP's wholesale and retail businesses.<sup>113</sup>

On June 1, 1984, TEP entered

into a power sale agreement in which TEP agreed to purchase Alamito's entire generation output for 12 years at formula-based rates that fixed the equity ratio used for determining rate of return at 43%. TEP subsequently spun off Alamito to TEP's stockholders as an independent power wholesaler. In 1985, the power sale agreement was amended to reduce the formula's equity ratio



to 30%. In June 1986, Alamito was sold to Catalyst Energy Corporation for \$232 million more than the price paid TEP at the time of the spinoff.<sup>114</sup>

The power sale agreement was again amended in October 1986 to provide (among other things) for the sale and leaseback of one of the generating units previously transferred by TEP to Alamito. The sale-leaseback arrangement reflected a price that exceeded the depreciated original cost of the unit by \$220 million.<sup>115</sup>

In a proceeding reviewing TEP's purchased power and fuel adjustment clause and its application to increase base rates, the ACC reviewed the results of these transactions. Its October 24, 1989

decision reveals a number of problems traceable to TEP's self-dealing. The ACC's decision is currently pending de novo review before the Arizona Superior Court<sup>116</sup> and has been challenged in federal court on grounds of federal preemption.<sup>117</sup>

**1. Lack of Arm's-Length Bargaining.** According to the ACC, TEP's power sale agreement with Alamito was drafted by TEP's chief counsel. It was signed on behalf of Alamito by TEP's chief financial officer and on behalf of TEP by TEP's senior vice president.<sup>118</sup>

The ACC found that "[t]he agreement was clearly one-sided in favor of Alamito. . . ."<sup>119</sup> The agreement obligated TEP to purchase all of Alamito's power priced on a fixed formula that set Alamito's equity ratio at 43% "when, in fact, it was only approximately 18%."<sup>120</sup> In addition, it allowed Alamito to terminate unilaterally its obligation to TEP at any time after May 31, 1989, but did not permit TEP to terminate even though it would have excess capacity after the June 1989 termination of its contract with San Diego Gas and Electric Company.<sup>121</sup>

As recounted by the ACC, when TEP began to consider spinning off Alamito, TEP's senior vice president raised concerns with TEP's chief executive officer regarding the contract. TEP's chief executive officer was "reluctant to change the agreement since it was necessary in order for Alamito to get independent financing."<sup>122</sup>

According to the ACC, in December 1984, TEP approved the spin-off of Alamito with the agreement still in place and without performing any economic analysis. TEP's chief executive officer and a number of the TEP officials involved with the Alamito contract left TEP and joined Alamito as officers as a result of the spin-off.<sup>121</sup>

The ACC concluded: "If the spin-off had been the result of an arms length transaction, free of self-dealing, we might have accepted it. However, that was not the case."<sup>124</sup>

**2. Risks to Ratepayers.** The Arizona Commission found that TEP's actions reflected "its emphasis on shareholder / management compensation and disregard for its customers and this regulatory Commission."<sup>125</sup>

The ACC found that TEP's decision to spin off Alamito without amending the power sale agreement threatened ratepayers with unneeded power at a high price. As a result of this decision, the subsequent sale of Alamito to Catalyst and the renegotiation of the agreement to include a sale-leaseback arrangement, TEP's lease payments reflect the inflated cost of the unit TEP transferred to Alamito.<sup>126</sup>

The ACC concluded:

*In essence, TEP continued to leave all the operating risk associated with [the two units] while Alamito enjoyed all the upside potential of selling the two plants at a gain. It was clearly an imprudent business decision to spin-off Alamito without amending the twelve-year Power Sale Agreement.<sup>127</sup>*

**3. Impairment of State Regulation.** The ACC found that TEP had been reluctant to submit to regulatory review of its activities.<sup>128</sup> It also found that TEP's motive for the Alamito spin-off, as it had informed the Internal Revenue Service, was to avoid the ACC's 16.5% limit on TEP's return on common equity.<sup>129</sup>

The ACC sought to remedy

*The examples discussed here demonstrate the need for increasingly vigilant regulation of utilities engaged in self-dealing with affiliates, not reduced regulation.*

TEP's imprudence by pricing the capacity purchased from Alamito at a level that prudent management could have obtained and adjusting for what it found to be excess capacity. This resulted in a \$45.5 million adjustment to TEP's test year operating expenses.<sup>130</sup> TEP has challenged the ACC's action in federal court on preemption grounds.<sup>131</sup>

### III. Conclusion

The Consumers Power, Southern California Edison and Tucson Electric examples demonstrate the need for increasingly vigilant regulation of utilities engaged in self-

dealing with affiliates, rather than the reduced regulation and increased avenues for self-dealing that would be allowed under the Johnston bill.<sup>132</sup> While the decisions discussed above could be modified or reversed on appeal, these decisions, even if they are overturned, demonstrate the enhanced incentive and opportunity for harmful self-dealing in the context of affiliated power producers.

These examples graphically underscore the corporate role of the affiliated power producer and the likely result: use of the "competitive" nonutility enterprise to siphon benefits to shareholders at the expense of ratepayers. Non-arm's-length transactions appear to have been designed to produce profits to the nonutility affiliate by increasing power costs and shifting risks to ratepayers. Impairment of state regulation is also a recurring theme.

Particularly in light of FERC's apparent tendency toward "market-based" pricing, utilities may see the opportunity to farm out to affiliates their responsibility to provide the resources to serve their growing loads and thereby reap profits in excess of a reasonable return on their investment. Elimination of FURCA restrictions will enhance utilities' already formidable ability to forum shop. By transferring existing and planned resources to a non-utility affiliate, utilities can seek FERC's effectively deregulated ratemaking, rather than state cost-of-service ratemaking, which may be preempted. While the John-

ston bill requires state commission approval before an existing resource is removed from rate base, that protection may prove inadequate in the interstate holding company situation<sup>12</sup> and does not address new generation.

Consumers Power's plans to transfer its Palisades nuclear plant to an affiliate (for resale of the output back to itself at non-traditional rates)<sup>13</sup> illustrate such a shift of generating resources from the regulated to nonutility subsidiaries. While the transfer of load-serving responsibility or generating resources to an affiliated power producer may appear to shift risks to the affiliate, this is not really the case. The financial problems of Pinnacle West Capital Corp. and its utility subsidiary, Arizona Public Service Co., teach us that utility ratepayers can bear a substantial financial burden when the utility's affiliates prove to be unprofitable.

Utilities are not ordinarily thought to be entitled to an extra "competitive" incentive—through nonutility affiliates—to do what they are bound to do in exchange for protected markets, the right to exercise governmental powers such as eminent domain, and protection from unreasonably low rates of return. Rather, they are obligated to meet their customers' requirements at the lowest cost. Nor does the potential for obtaining lower power costs as a result of competition from truly independent power producers provide a basis for paying utilities more than their costs to do their jobs.

The case studies above illustrate that utilities are not setting up subsidiaries to sell power to their customers at a lower cost than would be the case without the extra corporate shell. That being so, the supposed benefits of diluting PУHCA protections and expanding opportunities for power transactions between utilities and their nonutility affiliates

*The case studies above illustrate that utilities are not setting up subsidiaries to sell power to their customers at a lower cost. That being so, the supposed benefits of diluting PУHCA protections and expanding opportunities for self-dealing should be questioned.*

should be questioned.

Indeed, a strong case can be made for simply prohibiting such transactions. A recent paper concluded that a policy prohibiting inter-affiliate transactions merits serious consideration. The economic benefits of such transactions are uncertain and small, while the costs of self-dealing and anticompetitive behavior, and potentially ineffective monitoring of such abuses, are significant.<sup>14</sup>

At the very least, any lifting of PУHCA restrictions on affiliated power producers must address and foreclose the obvious potential for self-dealing by requiring that power sales to an affiliated utility be made at the lowest of the utility's costs, the affiliate's costs, or market price (if one can be established). Such a rule would eliminate the incentive for much of the maneuvering seen in the case studies.

The competition sought to be achieved by eviscerating PУHCA may prove illusory, particularly if these protections are eliminated without providing a means for public and private utilities to have access to the transmission facilities and coordination services they need to reach alternative resources (including projects of true independents). Real competition, including a robust secondary market for short and long term resales of resources, cannot exist without effectively open access to transmission services.

Franchise and yardstick competition,<sup>15</sup> by which a utility's rates are compared with those of neighboring electric systems, should temper a utility's willingness simply to increase rates to fill the coffers of affiliates and stockholders. But yardstick and franchise competition cannot serve this function if competitors are denied market access equivalent to that enjoyed by the larger utilities. As the case studies illustrate, the granting by utilities of preferential transmission access to their affiliates is not a hypothetical problem.

If the Public Utility Holding Company Act is to be weakened to promote competition from independent power producers—a proposition the need for which is yet to be proved—enforceable restrictions should be placed on utility-affiliated power producers. These restrictions should constrain their dealings with affiliated utilities and should require utilities that create affiliated nonutility suppliers to make transmission and coordination services available to all players in the market on an equivalent basis. These two principles are fundamental to creating an arena in which competition can operate to reduce costs to consumers. ■

## Footnotes

1. PUHCA § 1(b)(2), 15 U.S.C. § 79a(b)(2), provides:

[(I)t is hereby declared that the national public interest, the interest of investors in the securities of holding companies and their subsidiary companies and affiliates, and the interest of consumers . . . are or may be adversely affected . . . when subsidiary public-utility companies are subjected to excessive charges for services, construction work, equipment, and materials, or enter into transactions in which evils result from an absence of arm's-length bargaining or from restraint of free and independent competition; when service, management, construction, and other contracts involve the allocation of charges among subsidiary public-utility companies in different States so as to present problems of regulation which cannot be dealt with effectively by the States. . . .

2. Amdt. 267 to S. 406, 101st Cong., 1st Sess. (1989).  
3. State regulation of the financial and

organizational structure of utilities and their holding companies forms a second line of defense. PUHCA does not preempt a state's authority to ban otherwise permissible holding companies. *Baltimore Gas & Elec. v. Heintz*, 760 F.2d 1408 (4th Cir.), cert. denied, 474 U.S. 847 (1985).

4. PUHCA § 9(a)(1), 15 U.S.C. § 79(a)(1).  
5. PUHCA § 9(a)(2), 15 U.S.C. § 79(a)(2).  
6. PUHCA § 10, 15 U.S.C. § 79.  
7. See PUHCA §§ 11, 12 and 13,



15 U.S.C. § 79k, 13. The Supreme Court recently put to rest arguments that Section 318 of the Federal Power Act, 16 U.S.C. § 825q, makes FERC's wholesale ratemaking authority subordinate to the SEC's jurisdiction over such inter-affiliate transactions (sales of goods and services other than electricity or natural gas). *Arcadia, Ohio v. Ohio Power Co.*, 58 U.S.L.W. 6015 (Nov. 27, 1990).

8. PUHCA § 3(a), 15 U.S.C. § 79(c)(a).  
9. See 17 C.F.R. § 250.2 (1990).

10. See *Environmental Action, Inc. v. SEC*, 895 F.2d 1255 (9th Cir. 1990). Even where the courts have taken the Act's dictates seriously, the SEC has been rather unresponsive. See *WPL Holdings, Inc.*, SEC Release No. 35-25096, 70-7305 (May 25, 1990), on remand from Wisconsin's Envtl. Decade, Inc., 882 F.2d 523 (D.C. Cir. 1989).

See also the SEC's pending rulemakings regarding diversification of registered and exempt holding companies. 55 Fed. Reg. 11,362 (1990) (to be codified in 17 C.F.R. § 250.52) and

55 Fed. Reg. 11,390 (1990) (to be codified in 17 C.F.R. § 250.52); 54 Fed. Reg. 6706 (1989) (to be codified in 17 C.F.R. § 250.17).

11. See S. Hempling, *Corporate Restructuring and Consumer Risk: Is the SEC Enforcing the Public Utility Holding Company Act?*, THE ELECT. J. 40 (July 1988).

12. 16 U.S.C. § 824 et seq.

13. 476 U.S. 953 (1986).

14. *Pike County Light & Power Co. v. Pennsylvania Pub. Util. Comm'n*, 77 Pa. Commw. 268, 465 A.2d 735 (1983).

15. *Mississippi Power & Light Co. v. Mississippi*, 487 U.S. 354, 373-74 (1988).

16. See *New Orleans Pub. Serv., Inc. v. Council of New Orleans*, 911 F.2d 993 (5th Cir. 1990).

17. See *Mississippi Power & Light Co. v. Mississippi*, 487 U.S. at 373-74; *Nantahala Power & Light Co. v. Thornburg*, 476 U.S. at 972.

18. *Dartmouth Power Associates Ltd. Partnership*, 53 FERC ¶ 61,117 at 61,358 (1990), slip op. at 9.

19. *Public Serv. Co. of Indiana*, 51 FERC ¶ 61,367, reh'g granted in part, denied in part, on other grounds, 52 FERC ¶ 61,260 (1990).

20. *Doewell Ltd. Partnership, Inc.*, 50 FERC ¶ 61,251 (1990).

21. *Dartmouth Power Associates Ltd. Partnership*, 53 FERC at 61,358-60. See also *Enron Power Enterprise Corp.*, 52 FERC ¶ 61,193 (1990).

22. *Doewell Ltd. Partnership, Inc.*, 50 FERC at 61,756; *Citizens Power & Light Corp.*, 48 FERC ¶ 61,210 (1989).

23. See *Portland Gen. Exch. Inc.*, 51 FERC ¶ 61,108, clarification granted, 51 FERC ¶ 61,241 (1990); *Terra Comfort Corp.*, 52 FERC ¶ 61,241 (1990).

24. See *Ocean States Power*, 44 FERC ¶ 61,261 (1988).

25. *TECO Power Serv. Corp. and Tampa Elec. Co.*, 53 FERC ¶ 61,202 (1990).

26. *Id.*, slip op. at 8. See also *Portland*

Can. Elec. Co., 53 FERC ¶ 61,216 (1990), accepting inter-affiliate transfer at the same "market" rate the affiliate charges third parties.

27. See Commonwealth Atl. Ltd. Partnership, 51 FERC ¶ 61,368 at 62,245 (1990).

28. See, e.g., TBCO Power Serv. Corp. and Tampa Elec. Co., 53 FERC ¶ 61,202, slip op. at 8.

29. 16 U.S.C. § 824a-3.

30. See 18 C.F.R. § 292.601 (1990).

31. See 18 C.F.R. § 292.602(c)(1)(ii) (1990).

32. See 18 C.F.R. § 292.602(b) and (c)(1)(ii) (1990).

33. 16 U.S.C. § 796(17)(C)(ii) and 18(B)(ii).

34. 18 C.F.R. § 292.206(b) (1990).

35. See CMS Midland, Inc., 38 FERC ¶ 61,244 (1987).

36. CMS Midland, Inc., 30 FERC ¶ 61,090 at 61,279, 61,286 (1990), *reh'g pending*.

37. Consumers Power Co., 66 PUR 4th 1, 2-3, 27 (MPSC 1985). See also Consumers Power Co., Case Nos. U-7830 Step 3A and U-9611 (MPSC May 23, 1990) at 2. The \$99 million annual increase was later reduced in several steps to \$78 million annually to recognize the proceeds of the sale of certain Midland assets. *Id.* at 4-7. The increase was in effect from August 24, 1985 to March 12, 1990, the date when Consumers Power moved to reduce the surcharges to zero. *Id.* at 4, 9.

38. FERC had certified the Midland facility as a QF on the representation by Consumers Power's wholly-owned subsidiary that, upon the facility's initial operation date, the equity interest held by an electric utility would not exceed 49%. CMS Midland Inc., 38 FERC at 61,827.

39. CMS Midland, Inc., 30 FERC at 61,269.

40. Midland Cogeneration Venture Limited Partnership, Case No. U-8671 et al. (MPSC June 22, 1989) 1, 15. Unless otherwise noted, all MPSC orders referred to pertain to this proceeding.

Appeals of the various orders issued in this proceeding are consolidated for review in *MCV v. MPSC*, No. 126536 (Mich. Ct. of App.).

41. *Id.* at 2-3.

42. *Id.* at 4.

43. *Id.* at 5-6.

44. *Id.* at 9.

45. *Id.* at 41, 46-47.

46. See Opinion and Order of Dec. 21, 1989 at 3; Opinion and Order of Sept. 26, 1989 at 3-4.

47. Opinion and Order of Dec. 21,

68. *Id.* at 30.

69. *Id.* at 40.

70. Consumers Power Co., Case No. U-9173 (MPSC May 3, 1990), at 24-25 (footnote omitted), *appeal pending*. Consumers Power Co. v. MPSC, No. 129908 (Mich. Ct. of App.).

71. *Id.* at 27.

72. Opinion and Order of Sept. 26, 1989 at 3.

73. Consumers Power Co., Case Nos. U-7830, Step 3A and U-9611 (MPSC May 23, 1990) at 2-4, 25.

74. *Id.* at 2-3, 25-26, 41.

75. *Id.* at 42.

76. A recent order by the Michigan Circuit Court indicates that the value of the proceeds from transfer of the Midland assets may exceed \$2 million. CMS Energy Corp. v. MPSC, Order on Remand from Supreme Court No. 89796 (Gingham Co. Cir. Ct. Nov. 6, 1990), appellate jurisdiction retained by the Mich. S. Ct., No. 89796.

77. *Id.* at 12, 14-18, 35-37.

78. *Id.* at 32.

79. *Id.* at 42.

80. The May 23, 1990 Order has spawned numerous appeals, including pending appeals before the Michigan Supreme Court (No. 89796), and before the Michigan Court of Appeals (No. 129241).

81. See, e.g., Brief in Support of Motion for Immediate Consideration, and Peremptory Reversal or, in the Alternative, Motion for Stay of Enforcement of May 23, 1990 Order, filed by CMS Energy, Consumers Power and a number of other affiliates in CMS Energy Corp. et al. v. MPSC, No. 129241 (Mich. Ct. of App.), dated May 29, 1990, at 20-33.

82. See Southern California Edison Co., Application No. 88-02-016, Decision No. 90-09-88 (CPUC Sept. 25, 1990) ("CPUC Decision") at 2-3, 8, 43, 121.

83. *Id.* at 4.

84. *Id.* The decision, which arose in the context of a proceeding regarding



1989 at 3, 6.

48. Opinion and Order of Feb. 22, 1990 at 9.

49. Order of Jan. 31, 1989 at 99.

50. *Id.* at 99-101.

51. *Id.* at 101.

52. *Id.* at 102.

53. Order of June 22, 1989 at 30-31.

54. Consumers Power Co., Case Nos. U-7830, Step 3A and U-9611 (MPSC May 23, 1990) at 32-33.

55. *Id.*

56. Order of June 22, 1989 at 21.

57. *Id.* at 38 (emphasis added).

58. *Id.* at 20.

59. Order of Jan. 31, 1989 at 103-04.

60. Order of June 22, 1989 at 40-41.

61. *Id.* at 42.

62. *Id.* at 10-11, 30.

63. *Id.* at 11.

64. *Id.* at 28.



Edison's Energy Cost Adjustment clause, ultimately will be subject to judicial review.

82. *Id.* at 3.

83. KRCC could unilaterally increase the contract capacity to 284 MW. *Id.* at 40.

84. *Id.* at 57, 62, 65-68, 74.

85. *Id.* at 66-67.

86. *Id.* at 60.

87. *Id.* at 68.

88. *Id.* at 138.

89. *Id.* at 138-39.

90. *Id.* at 21-26.

91. *Id.* at 127.

92. *Id.* at 128. *See also id.* at 128-30.

93. *Id.* at 46, 128, 130.

94. *Id.* at 132.

95. *Id.* at 48-49, 132.

96. *Id.* at 132.

97. *Id.* at 131, 155. In 1988, after commencement of the DRA investigation, Edison and KRCC amended the contract to attempt to cure some of the problems with the maintenance and termination provisions. *Id.* at 75-76. Notwithstanding the purported retroactive effect of the amendment, the CPUC found the amendment to be irrelevant to the record period, which pre-dated the amendment. *Id.* at 134.

98. *Id.* at 154.

99. *Id.* at 135, 154-56, 192.

100. *Id.* at 146, 186.

101. *Id.* at 135-36.

102. *Id.* at 146.

103. *Id.* at 136.

104. Report on the Reasonableness of Southern California Edison Non-standard Power Purchase Contracts with Qualifying Facilities, prepared by the Staffs of the Energy Resources Branch and the Energy Auditing Branch of the DRA, submitted in CPUC Application No. 88-02-016, Dec. 1988, at IV-30.

105. *Id.* at IV-26 (emphasis added).

106. *See* Concurrent Opening Brief of Southern California Edison Company

(L' 338-E) Regarding the Reasonableness of Execution and Administration of the Kern River Cogeneration Company Contract, June 26, 1989, filed in CPUC Application No. 88-02-016, at 89-99.

107. CPUC Decision at 166-67.

108. FERC Docket No. EC89-5-000 and CPUC Application No. 88-12-035. In the CPUC merger proceeding, the DRA is again seeking divestiture. *See* SCEcorp. Southern California Edison Co. and San Diego Gas & Electric Co., CPUC Application No. 88-12-035, Exh. 10,000 at VII-3.

109. Initial Post-Hearing Brief of the U.S. Department of Justice, FERC Docket No. EC89-5-000, filed June 15, 1990, at 2-3.

110. *Id.* at 3 (footnote omitted).

111. Southern California Edison Co. and San Diego Gas and Elec. Co., 53 FERC ¶ 63,014 (1990), slip op. at 50. The initial decision is subject to exceptions by all parties and review by FERC.

112. *Id.* at 49-50.

113. *See* Tucson Elec. Power Co., Docket Nos. U-1933-88-280 and U-1933-88-090, Decision No. 56659 (ACC Oct. 24, 1989) ("ACC Decision") at 7. The Tucson-Alamogordo relationship is also detailed in the October 1990 issue of this journal at 8.

114. *Id.* at 7-9. *See also* Tucson Electric Power Co. v. Arizona Corp. Comm'n., No. CIV 90-049 PHX WPC (D. Ariz. Sept. 17, 1990), slip op. at 2-3.

115. ACC Decision at 9-10.

116. Tucson Electric Power Co. v. Arizona Corp. Comm'n., CV 89-21244, CV 89-35498, CV 89-35828 (Ariz. Super. Ct.).

117. Although the District Court recently granted summary judgment in favor of the ACC, Tucson Elec. Power Co. v. Arizona Corp. Comm'n., CIV 90-049 PHX WPC (D. Ariz. Sept. 17, 1990), the order is subject to appellate review.

118. ACC Decision at 8-11.

119. *Id.* at 8.

120. *Id.* at 63. *See also id.* at 8-9.

121. *Id.* at 8 and note 2.

122. *Id.* at 8.

123. *Id.* at 8-9, 64.

124. *Id.* at 11.

125. *Id.* at 60.

126. *Id.* at 9-12.

127. *Id.* at 11 (emphasis in original).

128. *Id.* at 60.

129. *Id.* at 7.

130. *Id.* at 11-12.

131. *See* note 117, *supra*.

132. These examples do not attempt to encompass potential abuses from reciprocal self-dealing schemes.

133. *See, e.g.*, the proposal, approved by the SEC over the objections of the Louisiana Commission, the City Council of New Orleans, and the Mississippi Attorney General by Arkansas Power and Light Co. to transfer its interest in two units to a new subsidiary for sales at rates to be negotiated in a "competitive" market. SEC Release No. 35-25136, 1990 SEC Lexis 2994 (Aug. 27, 1990), *appeal pending*, City of New Orleans v. SEC, D.C. Cir. No. 90-1493; Louisiana Pub. Serv. Comm'n. v. SEC, D.C. Cir. No. 90-1506. The associated power coordination and transmission contract was approved by FERC, *See* Entergy Services, Inc., 51 FERC ¶ 61,376 (1990), *reh'g denied*, 52 FERC ¶ 61,317 (1990), *appeal pending*, City of New Orleans v. FERC, D.C. Cir. No. 90-1494.

134. The lawfulness of the repurchase by Consumers is under review by FERC and the MPSC. *See* Palisades Generating Co., 48 FERC ¶ 61,144 (1989); Consumers Power Co., 52 FERC ¶ 61,023 (1990); Palisades Generating Co., 52 FERC ¶ 61,264 (1990), *reh'g granted in part, denied in part*, 53 FERC ¶ 61,239 (1990), *appeal pending*, D.C. Cir. No. 90-1580; Consumers Power Co., MPSC Case No. U-9507.

135. CHARLES RIVER ASSOCIATES, INC., SELF DEALING AND UTILITY GENERATION PURCHASES: PRECEDENTS AND OPTIONS 22-23 (Jan. 1990).

136. *Cf.* Power Authority of New York v. FERC, 743 F.2d 93, 105 (2d Cir. 1984).

**AMERICAN BAR ASSOCIATION  
SECTION OF NATURAL RESOURCES, ENERGY,  
AND ENVIRONMENTAL LAW**

**Who Needs PUHCA?**

**Presented by  
Ronald E. Russell, Commissioner  
Michigan Public Service Commission  
March 8, 1991**

In the controversy surrounding the push toward competitive wholesale electric markets, many voices are heard to say that the Public Utility Holding Company Act of 1935 (Holding Company Act or PUHCA) is archaic, no longer serving the public interest and actually impeding progress toward the "benefits of enhanced competition." One hears that the abuses of the 1930s are no longer prevalent and the flower of true competition is just waiting to unfold in the electric industry (if only PUHCA would get out of the way).

We, in Michigan, have had a unique opportunity to examine what the future might be like without the protections afforded by the Holding Company Act. The Public Utility Regulatory Policies Act of 1978 (PURPA) opened the regulatory-safeguard door when it permitted utility monopolies to create affiliated qualifying facilities without review under the Holding Company Act. Revisions to the Act, such as those proposed by Senator J. Bennett Johnston, would remove the door. In the next few minutes I would like to use the example of CMS Energy Corporation to illustrate the complexities and challenges that state utility regulators face when exemptions to the Holding Company Act are allowed. I will leave it to you to extrapolate from our experiences.

Before I get started, let me make it perfectly clear that I am speaking only for myself. The opinions and characterizations included in my remarks today are attributable only to me.

CMS Energy Corporation is a utility holding company with at least 40 subsidiaries and affiliates that we are aware of. The largest of these is Consumers Power Company which is a combination electric and gas utility with approximate annual operating revenues of \$1.7 billion from 1.4 million electric customers and \$1.1 billion from 1.3 million gas customers (1989 Annual Report). In a January 1991 press release, CMS Energy described itself as "a \$3 billion (sales) diversified energy holding company with businesses engaged in the distribution of electricity and natural gas, interstate storage and transmission of natural gas, oil and gas exploration and production, independent power generation and utility services."

affiliates. In the case of CMS Energy, the same seven or eight names appear time after time as officers and directors of numerous affiliated entities.

The advent of cogeneration and competitive supply acquisition greatly magnifies the potential for excessive "intrasystem charges." The case record in U-8871, Midland Cogeneration Venture's application for approval of the power purchase agreement between itself and Consumers Power, clearly revealed an absence of arms' length bargaining between the two affiliates to the detriment of both the ratepayers and the non-affiliated cogenerators who hoped to sell power to the utility. By some coincidence, individual officers and managers appeared to bargain much harder when they were "wearing their affiliate hats" than when they were representing the utility in negotiations.

The terms of the contract between Consumers Power and MCV are too complex to go into here. Suffice it to say that the contract includes a number of unusual provisions that protect the MCV, rather than Consumers Power, in the event of any disallowances by the Michigan Commission. The contract also provides that if MCV ever loses its status as a qualifying facility, the MCV – not the utility – has the option of either terminating the contract or continuing to deliver capacity under a tariff regulated by the FERC.

After reviewing the litany of self-dealing abuses that characterized the record in the U-8871 proceeding, I, along with my fellow Commissioners, was moved to make the often quoted remark that "... one must wonder whether Consumers has once again negotiated with itself and lost." (U-8871 et al, Opinion and Order dated June 22, 1989).

Abuses were also found on the gas side. In U-8867-R, Consumers Power's 1988 Gas Cost Recovery (GCR) reconciliation, subsidies by Consumers Power of the MCV were found by the Michigan Commission. As an agent for the MCV, Consumers Power negotiated package deal contracts that inequitably allocated to the MCV certain benefits arising from the combined leverage of negotiating contracts for both companies with the same producers. A disallowance of unreasonable and imprudent gas costs of \$2.5 million was ordered.

In testimony in U-9433, Consumers Power's 1990 GCR Plan, Commission staff analyzed the question of improper subsidization, and identified several aspects of what it calls unfair bargaining on the part of Consumers Power. Three significant improprieties are alleged by staff: 1) the timing of purchase obligations, e.g., Consumers Power was required to take the gas as soon as it was available, whereas the MCV was under no such obligation, 2) a price advantage for MCV over Consumers Power, e.g., weighted average gas acquisition costs were used in Consumers Powers' contracts and fixed escalators or coal-tied prices in the MCV's, and 3) the risk of significant changes in gas markets, e.g., the risk of a change from a buyers' market to a sellers' market is exclusively laid on the backs of the Consumers Power GCR customer through price reopener and contract termination clauses, while the corresponding MCV contracts do not contain any such provisions.

The volume, complexity and expense of litigation related to CMS Energy's activities to date is unprecedented. It is commonly remarked that one of CMS Energy's strategies is to try and render the Michigan Commission ineffective by overloading our staff and legal resources. Other Michigan utilities have been heard to complain that they do not get timely attention to their issues because staff is tied up on the multitude of CMS-related cases. While we make every effort to ensure that all regulated utilities receive expeditious treatment of their applications, it is true that a disproportionate amount of resources are spent on efforts to regulate Consumers Power Company. This situation can only get worse if revisions to the Holding Company Act encourage all of our electric utilities to emulate Consumers Power Company.

**STATEMENT 2:**

"Holding company promoters did not confine their acquisitions of utility properties to any one geographic area or region; . . ."

CMS Energy has actively publicized its efforts to acquire an interest in utility plants in other states, such as Rancho Seco in California and Shoreham in New York. CMS is reportedly also pursuing utility opportunities internationally. With respect to its activities within Michigan, CMS Energy and/or its subsidiaries have become affiliated with many national and international corporations including Dow Chemical, Panhandle Eastern Corporation, Asea Brown Boveri, Fluor Corporation, Combustion Engineering and Bechtel Corporation among others.

**STATEMENT 3:**

"...with operating properties on both coasts and the Gulf of Mexico, the scattered service territories of these early holding companies often bore no economic or functional relationship to each other or to other businesses in the holding company system. The growth and profitability of the electric and gas utility industries afforded opportunities to holding companies to profit handsomely from intrasystem charges for management and engineering services and to issue securities based on inflated utility property prices, resulting in higher customer rates, to help finance further acquisitions."

Present day experiences with holding companies frequently reveal a slightly different twist to what occurred in the 1930s. Most of the regulatory conflict I have seen derives from functionally-related activities. While these activities may tend to appear somewhat less risky in that the utility is not venturing forth into areas about which it knows nothing, there is a significantly greater risk of diversion of management talent and attention, as well as other resources, to the non-regulated activity.

Opportunities for business transactions which favor holding company shareholders at the expense of utility ratepayers abound when officers of the utility also head up non-utility

affiliates. In the case of CMS Energy, the same seven or eight names appear time after time as officers and directors of numerous affiliated entities.

The advent of cogeneration and competitive supply acquisition greatly magnifies the potential for excessive "intrasystem charges." The case record in U-8871, Midland Cogeneration Venture's application for approval of the power purchase agreement between itself and Consumers Power, clearly revealed an absence of arms' length bargaining between the two affiliates to the detriment of both the ratepayers and the non-affiliated cogenerators who hoped to sell power to the utility. By some coincidence, individual officers and managers appeared to bargain much harder when they were "wearing their affiliate hats" than when they were representing the utility in negotiations.

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In addition to the potential negative rate impacts from holding company affiliate self-dealing, many allegations of anti-competitive behavior have surfaced. Practices such as inappropriate sharing of information between affiliates, denial of access to transmission services, prohibitive contract terms for non-affiliates (as opposed to more flexible terms for affiliates), and many other practices have been brought to light. (See article by Cindy Bogorad, "Self Dealing: The Case Against Removing PUHCA Restriction on Utility-Affiliated Power Producers," *The Electricity Journal*, Jan/Feb 1991.)

**STATEMENT 4:**

"These holding companies typically were highly leveraged and characterized by layer upon layer of partially-owned subsidiaries. The bulk of the capitalization of the holding-company system consisted of public non-voting debt and preferred stock. Consequently, effective control of extensive utility systems could be acquired with minimal equity investments by small groups of investors who exploited the subsidiary operating companies for their own gain at the expense of other investors and consumers."

With respect to the value of utility properties, a trend seems to be developing which would allow a non-regulated affiliate to benefit from the market value of a former utility asset, which was transferred to the affiliate at book value.

CMS Energy was formed in 1987 with no assets other than those that belonged to Consumers Power. Since that time, a process of decapitalizing Consumers Power to transfer assets to CMS Energy and affiliates seems to be underway. Two examples of this include the well-publicized Midland Cogeneration Venture, which is now a 1350 MW gas cogenerator with a contract to sell power to Consumers Power, and Palisades Generating Company (PGC), which is currently in the process of trying to become the nation's first nuclear independent power producer – or more correctly – affiliated power producer. The PGC is a corporation formed by Consumers Power, Bechtel and Westinghouse, to transfer the Palisades Nuclear Plant from Consumers Power to PGC and then sell power back to the utility under a seventeen year contract. Proceedings related to this project are presently underway before the FERC and the Michigan Commission. Applications for regulatory approvals have also been filed at the SEC and the Nuclear Regulatory Commission.

In addition to transferring assets away from the utility, we are seeing such things as decisions to retire non-mandatory preferred stock and thereby further reduce equity ratios even when the economics dictate otherwise (U-9594, U-9595). Such decisions could have the effect of providing greater control to shareholders of the holding company while increasing long-term ratepayer costs and exposure of the utility.

A recent complaint filed by Michigan's Attorney General in a Consumers Power securities case (U-9107) is typical of the allegations that have surfaced. In this case, the

Attorney General is arguing that Consumers Power does not need to issue additional securities because it would have sufficient funds if only it would quit transferring assets to non-regulated affiliates, exchanging liquid utility assets for less marketable instruments from CMS Energy and voluntarily diminishing its cash flow for the benefit of its parent.

In view of the kind of activities we've seen in Michigan, I find it extremely difficult to understand how Senator Johnston and other proponents of so-called "PUHCA reform" can deify the pursuit of competitive generation in the electric industry, while remaining apparently oblivious to the potential for interaffiliate abuses. Self-dealing and other anti-competitive activities not only could result in excessive retail rates, but also stand to subvert the new competitive regime by providing unwarranted subsidies and other advantages to a few "competitors" to the detriment of all others.

Some of you out there are undoubtedly thinking, "Hey, he's just made our argument for us: He's demonstrated that states can effectively uncover affiliate abuses and correct for them." To you, I have this to say: Relying solely upon after-the-fact rate reviews to protect consumers from utility holding company abuses is like trying to eat a meal with only one chopstick and both hands tied behind your back. You can be somewhat effective holding the chopstick with your feet and bringing food up to your mouth, but there are many foods that you won't be able to manage completely and more that you couldn't even attempt. State utility commissions can, and will, become virtuosos with our single chopsticks. However, we can only address what we can uncover and conclusively document.

The key to mitigating utility abuses is to prevent them from happening in the first place. The pre-acquisition reviews that are provided for in the Holding Company Act are intended to prevent the creation of corporate structures and transactions that are inherently susceptible to abusive behavior. The more complex the corporate relationships, the more difficult it becomes to detect abusive transactions.

Human nature has not changed since the 1930s. If the stage—or should I say table—is once again set for utility holding company abuses, those abuses will occur.

If Senator Johnston's goal is to have full and fair competition in the generation sector, I can support that goal. I recognize that government cannot legislate morality or corporate philosophy. However, if we are going to reshape regulation to encourage competition, let's encourage fair competition and not set ourselves up for a repeat of the abuses of the 1930s. The Congress can and should reduce, not increase, the opportunities for improper actions by utility holding companies.

In the background paper he provided to accompany Title XV of his National Energy Security Act of 1991, Senator Johnston clarified some of the thinking that went into his bill. I commend the Senator for his willingness to share his ideas, but I find it necessary to challenge some of his most basic assumptions.

In his eagerness to expand the universe of those who can enter the competitive generation market without becoming a utility holding company, the Senator seems essentially unaware of the monopoly advantages that will still be retained by the investor-owned utility companies. These advantages include a captive customer base and control over the existing generation, transmission and distribution systems as well as all the financial resources they engender.

Creating exempt wholesale generators will not in and of itself stimulate a truly competitive market. Regulated utilities are the primary customers of the would-be wholesale generators. As long as they retain both the exclusive control of the national transmission system -- and the ability to opt out of the competitive marketplace -- utilities will retain all of the advantages that their monopoly positions give them plus they will gain new opportunities for configuring themselves to extract monopoly profits from their customers.

The basic question of PUHCA revision (in my mind) revolves around the definition of a utility's obligation to serve. Is it the utility's obligation to maximize corporate profits and -- oh, by the way -- deliver electricity, or is it to serve its franchise monopoly customers in the most efficient way possible with an opportunity for a fair rate of return? ] ?

While it is true that state regulators set the rates that can be charged to these captive customers, most state commissions are designed and staffed to regulate stand-alone, vertically integrated utilities. There may be a few instances where a state commission's jurisdiction to examine the books and records of non-regulated affiliates of utilities is undisputed. However, this is not generally the case.

Some of the examples I mentioned earlier reflect the positions of various parties in ongoing cases. The Commission has not yet made any finding with respect to these cases. However, I have included them here because they help illustrate the kinds of allegations that state regulatory commissions will have to devote increasing amounts of resources to investigate, whether or not the alleged abuses actually occur.

In addition to the difficulties involved with investigating alleged abuses of multiple utility holding company affiliates in the face of disputes about access to affiliate books and records, there is another problem that is worth mentioning.

In most cases, utility regulatory commissions have clear authority to disallow unreasonable and imprudent costs incurred by a utility. However, there is a limit to the amount and frequency of disallowances that can be made before a commission must become concerned with the financial viability of the utility. If one assumes that the parent company subordinates the interest of the utility to the interests of the holding company itself, and therefore continually places the utility at risk, state commissions could easily find themselves in a "damned if you do, damned if you don't" situation.

*Too big to fail*



Any legislation which removes virtually all restraints on a utility's ability to create numerous generating affiliates and partnerships – without substantially strengthening the states' ability to address the concomitant anti-competitive abuses – is untenable. At best, it would result in a business boom for anti-trust lawyers. At worst it could expose U.S. citizens to unconscionable rate disparities (to the extent that they could not be mitigated by local regulatory commissions) and frustrate a national goal of greater competition in the generating sector.

With all due respect to Senator Johnston, it is a fallacy to assume, as he does, that the regulatory regimes that have been enacted subsequent to PUHCA "to a large extent provide duplicative protection" and that "The Holding Company Act...has become...superfluous." Let me suggest that the opposite is true: Subsequent legislation was enacted with both the knowledge that the Holding Company Act protections against anti-competitive behaviors were in place and the assumption that they would continue to remain in place.

If it is the will of Congress to remove the protections that the Holding Company Act provides, let them clearly understand that in so doing they are creating not only a new category of competitors, but also resurrecting and energizing a group of "anti-competitors" who may seek to take unfair advantage of their monopoly power.

Who needs PUHCA? I submit that monopoly ratepayers, state regulatory agencies, and this country need it. I also submit to you that the protections of the Public Utility Holding Company Act are just as relevant today as they were in 1935. Vigorous enforcement of the Act is increasingly called for, and any changes to the Act which are intended to increase competition in the generation market should, at a minimum, prohibit utility ownership of generation in their own service areas under the guise of independent or separate companies, retain the limitations on the extent of corporate complexity and provide state regulatory bodies with undisputable access to records of transactions between a utility and its affiliates.

Thank you for your attention.

TESTIMONY OF  
SCOTT HEMPLING  
ATTORNEY  
ON BEHALF OF  
ENERGY PROJECT  
ENVIRONMENTAL ACTION FOUNDATION  
BEFORE THE  
SUBCOMMITTEE ON SECURITIES  
COMMITTEE ON BANKING  
UNITED STATES SENATE  
ON  
PRESERVING THE PUBLIC UTILITY HOLDING COMPANY ACT

Sept. 17, 1991

## ABSTRACT

Today's electric markets are flawed. They are marked by systematic anticompetitive practices in the generation and transmission sectors. These practices harm consumers, as well as small independents, municipal systems and rural electric cooperatives -- the very entities who can bring fair competition to this industry. Merely adding new players, or permitting expansion by existing large players, will not cure these problems.

Utilities cast the electricity debate as a debate over two possible worlds: "competition," represented by utilities seeking to weaken the Public Utility Holding Company Act ("PUHCA" and "no competition," represented by the utilities opposing change to PUHCA. That is a false dichotomy. There are in fact three possible worlds: "no competition," "unfair competition" and "fair competition." Freeing utilities to expand without review represents "unfair competition." Weakening PUHCA may add competitors; but it will not add competition.

Proposals to weaken PUHCA would enact the most drastic structural change in the electric industry in over 50 years. These proposals are disguised as "narrow fixes;" but broader legislation is difficult to imagine.

In order to enhance competition, we must address existing anticompetitive practices directly. These proposals assume those practices away. Worse, they reward anticompetitive practices by freeing the anticompetitors to expand into new territories without regulatory review.

Today's electric industry also is marked by great uncertainty over the quality and predictability of state and federal regulation. No one is sure who has jurisdiction over which types of transactions. No one is sure if regulators have the tools necessary to anticipate and meet the new challenges posed by a rapidly restructuring industry. The proposals assume this problem away as well.

Many state legislatures have not given their commissions statutory authority to deal with the problem of expanding utilities, because federal statutes like PUHCA have prevented or monitored them. We cannot eliminate federal standards and protections without knowing that state standards and protections will replace them. Some standard and protection is necessary.

Even if we solve the problems of state jurisdiction and state statutory authority, the question of resources looms. Two of our largest states -- California and Michigan -- have encountered unprecedented regulatory difficulties as utilities engaged in corporate restructuring and anticompetitive practices.

Furthermore, today the ramifications of changing the electric industry go beyond affecting the consumers pocketbook,

to the question of the environment. While states implement least-cost planning and promote conservation programs to meet future energy needs, these efforts will be fruitless if Congress does not ensure a level playing field for demand-side conservation and supply side options. If new regulation promotes building new generation by presenting opportunities for utilities to earn unequitable returns on their investments without the consideration of environmental externalities, then utilities will continue find ways around state least-cost plans and ignore conservation opportunities.

We cannot assume strong competition in an industry which is anticompetitive. We cannot assume strong regulation in an industry which is fast become unregulated. Title XV of the bill approved by the Energy Committee makes both errors.

The Public Utility Holding Company Act is the essential statutory protector of competition and consumers. Among other things, the Act --

1. Bars utility acquisitions which monopolize new territories or new power sources, or which create risks to consumers or investors. See Section 10(b)(1), (2), (3).
2. Demands that utility acquisitions "serve the public interest by tending toward the economical and efficient development of an integrated public-utility system." See Section 10(c)(2).
3. Limits utility speculation in unrelated ventures (e.g., banks, real estate, distant utility businesses), where that speculation imposes risks on electric customers. See Sections 1(b), 11(b)(1).

PUHCA played a central role in breaking up the large holding companies that once plagued the nation. But the tendency toward concentration has not disappeared. As the Honorable Ronald Russell of the Michigan Public Service Commission has stated, "human nature has not changed since the 1930s."<sup>1</sup> Proposals to weaken PUHCA ignore this simple fact. By repealing key protections, they would leave consumers, competition and regulation substantially unprotected from utility monopolization.

Yet the status quo is not adequate either. Under the status quo utilities use their monopoly power over transmission

<sup>1</sup> Commissioner R. Russell, "Who Needs PUHCA?", Speech Before the American Bar Association, Section of Natural Resources, Energy and Environmental Law (Mar. 8, 1991) [hereinafter cited as "Comm. Russell Speech"].

facilities to deny competitors nondiscriminatory, economic access to wholesale markets, at the same time that the utilities themselves expand into those very markets by evading key provisions of PUHCA. Some change clearly is necessary. This testimony presents a proposal for that change.

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TESTIMONY OF  
SCOTT HEMPLING  
ENVIRONMENTAL ACTION FOUNDATION

Mr. Chairman and Members of the Committee:

My name is Scott Hempling. I am an attorney in private practice in Washington, D.C., appearing on behalf of the Energy Project of Environmental Action Foundation ("EAF"). EAF is a nonprofit, research and education organization concerned with energy and environmental issues.

I appreciate the opportunity to participate in this historic debate on the changing electric industry. My testimony has four parts. Part I analyzes the threats to consumers and competition in today's industry today and explains how these threats would be exacerbated by proposals to weaken the Public Utility Holding Company Act ("PUHCA" or "the Act"). Part II outlines a proposal for eliminating these threats so that consumers can realize the benefits of competition. Part III responds to those utilities who seek to weaken PUHCA without regard for the fairness of competition. Part IV responds to those utilities who seek to avoid competition altogether.

I. UTILITIES ARE RESTRUCTURING TO WEAKEN COMPETITION AND REDUCE REGULATORY OVERSIGHT

A. Overview

Many utilities today are restructuring their corporate form and changing their strategic plans. Their goals are to (1) dilute or avoid state regulation, (2) compete unfairly against "true independents," and (3) shift business risks to while earning returns which not sustainable in a competitive market.

Present proposals to weaken PUHCA will make matters worse. These proposals fail to distinguish between two types of entities: (1) entities financed, owned and controlled by utilities with monopolies over distribution or transmission markets; and (2) "true independents," i.e., those entrepreneurs who raise and risk their own capital, unassisted by a distribution or transmission monopoly.

In this confused world, utilities will use captive customers to finance expansion into distant territories. They will describe themselves as "independent power producers" and "exempt wholesale generators." But a utility affiliate acting as an "independent power producer" is an oxymoron. When a utility with a distribution or transmission monopoly creates, finances, owns and controls another company, that company is not independent. And under proposals to weaken PUHCA, not just utilities but any corporation from any industry could enter the market anywhere,

acquire as many wholesale utilities as they desire, and face no advance review under PUHCA.

Some have framed the debate over PUHCA as a debate over whether we should have competition. But the goal of competition is not disputed, except by some utilities fearful of that competition. Thus the real questions are:

How do we promote vigorous, permanent and fair competition, as distinct from temporary rivalries marked by anticompetitive practices?

How do we ensure that in the competition, conservation has a chance to compete with construction?

To answer these questions properly, we must review how utilities are distorting competition today. They are doing so in at least five ways.

#### B. Utilities are Creating Affiliates to Weaken Competition and Consumer Protection

1. Creation of Utility Affiliates Leads to Harmful Self-Dealing: Abusive self-dealing occurs when the customers of the monopoly utility pay an above-market price for a service or good supplied by an affiliate. Self-dealing is inconsistent with the "regulatory compact" -- the utility's obligation to serve the public at least feasible cost. According to the Honorable Ronald Russell of the Michigan Public Service Commission, 2

corporate structure, and transactions between corporate affiliates, can be manipulated to embrace the concept of competitive generation while insuring that all competitive advantages reside with holding company affiliates.

A technical description of self-dealing appears in Appendix A.

2. Utilities Are Using Affiliates to Force Captive Customers to Subsidize Expansion Into New Territories: Utility expansion into new markets raises the same problems as does utility diversification into unrelated businesses risk of failure, diversion of utility profits from measures which would strengthen the utility's financial condition reduced utility maintenance, the "draining of top management from the core utility, and cross-subsidization

A utility cannot argue, simultaneously, that (1) it has resources and management skills that can benefit other

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2 See Comm. Russell Speech, supra.

territories, and (2) that it is retaining its best resources and management for the local utility business. The best managers cannot be in two places at the same time.

3. **Proposals to Weaken PUHCA Will Make Self-Dealing Worse:** The Public Utility Regulatory Policies Act of 1978 erred in permitting utilities to form affiliates without review under PUHCA. Current proposals to weaken PUHCA, such as the one approved by the Senate Energy Committee, would expand this authorization. These proposals also directly eliminate existing protections against self-dealing. A utility could acquire unlimited numbers of exempt wholesale generators ("EWGs") in an unlimited number of states.

Under PUHCA today, a holding company with wholesale utility subsidiaries spread across several states would be a registered holding company like Entergy or American Electric Power. As a registered holding company, its interaffiliate transactions would be reviewed by the SEC. The present proposals would eliminate all this review.

#### C. Utilities Are Using Corporate Form to Escape State Law and Regulation

In the 1970's, utilities initiated large capacity expansion programs, based on projection of high demand and moderate construction costs. These projections were wrong. State regulators consequently excluded a substantial amount of utilities' construction investment from retail rates. Disappointed utilities now seek to minimize future state regulatory scrutiny by creating wholesale subsidiaries regulated by FERC, but unregulated by states.

In Mississippi Power & Light v. State of Mississippi, 487 U.S. 354 (1988), the U.S. Supreme Court held that FERC's allocation of power plant construction capacity among the utility subsidiaries of a centrally planned holding company preempted state commission review of the subsidiaries' decision to participate in that construction. The resulting uncertainty over state regulation has slowed innovations like least cost planning and competitive bidding. According to the Arkansas Public Service Commission:

Integrated resource planning requires direct action by, and collaboration between, state regulators and utilities. To bring discipline to the process state commissions need legal clout. But uncertainty over state legal authority, including the threat of federal preemption, is hampering states' ability to bring integrated resource planning to registered holding company systems. Put another way, integrated resource planning requires state-based comparison of generation,

conservation and load management options. It is not possible to conduct this comparison on a state-by-state basis when the in-state subsidiary takes orders from a multistate parent. 3

Under Section 201 of the Federal Power Act, FERC does not have jurisdiction over "generating facilities." Thus FERC lacks clear authority to conduct integrated resource planning. When a utility shifts to FERC regulation, it is doing more than avoiding state regulation; it is escaping integrated resource planning completely.

The law in this area is very uncertain. Federal legislation is necessary to clarify the states future role. Until then, any proposal to ease the creation of utility affiliates by repealing PUHCA will weaken state regulation further.

#### D. Utilities Are Using Their Transmission Monopolies to Create Generation Monopolies

Transmission facilities are the highways of commerce. Generators cannot compete fairly unless they can move their products to market and unless buyers can access the least expensive product. The major transmission highways are owned by investor-owned companies with retail monopoly franchises. These utilities create anticompetitive "bottlenecks" by denying access to others. See Appendix B.

Proposals to weaken PUHCA ignore this fact of life. Absent PUHCA's restraints on unlimited expansion, utilities can (1) create affiliates to serve distant markets, (2) grant preferential transmission access to the affiliates, and thereby (3) prevent others from competing in those markets. PUHCA amendment and transmission access is linked, inseparably, by the reality of this industry.

#### E. Diversification -- The Mixing of Utility and Non-Utility Business -- Is Increasing Consumer Risks

Two kinds of utilities are turning to diversification. One group, which includes Wisconsin Power & Light, seeks new outlets for excess cash. Another group, which includes Kentucky Utilities, expects to fare poorly in an electric industry which has more competitors. Both types hope to use their name recognition and preferred access to capital, gained through their exclusive retail monopolies, to make new profits in nonutility businesses.

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3 Testimony before U.S. Senate Committee on Energy and Natural Resources (Mar. 14, 1991).

Utility diversification has been an unhappy experience. Arizona Public Service Company's affiliation with a savings and loan association, MeraBank, brought the parent holding company, Pinnacle West, to the brink of bankruptcy. Although the SEC is required to review diversification by any utility using the holding company form, its inaction makes it an unreliable protector.

1. **The Potential Damage of Diversification Puts Ratepayers at Unfair Risk:** The debacle of Pinnacle West highlights not only the SEC's failure to regulate, but also the severe ramifications on the utility itself when diversification ventures go awry. Pinnacle West Capital Corporation is the parent holding company of Arizona Public Service. In 1986, Pinnacle West's corporate predecessor acquired MeraBank for \$426 million. MeraBank was a Savings and Loan institution. According to the Arizona Corporation Commission, the \$426 million price was two times MeraBank's book value; about 80% of the acquisition cost represented an acquisition premium, and was recorded on the books as good will.

As an exempt holding company, Pinnacle West was entitled to retain its exemption only "unless and except insofar as [the Commission] finds the exemption detrimental to the public interest or the interest of investors or consumers ..." Section 3 a) of the Act. Several months before the acquisition, the SEC wrote to the holding company, requesting an explanation as to the rationale supporting the holding company's continued exemption in light of the proposed acquisition. The holding company responded that "MeraBank has an established record of continuing growth which will contribute favorably to the [holding company].... in no event may APS's financial resources be directly or indirectly committed or pledged to accomplish the acquisition." The SEC apparently accepted this explanation; I am aware of no further communications from the SEC to the holding company.

The SEC's acceptance of Pinnacle West's explanation, coupled with its failure to pay any attention to post acquisition developments, led to the largest diversification loss in the electric industry since the statute was enacted.

1. On December 31, 1988, MeraBank recorded a loss of \$209 million, virtually cancelling out APS' net income that year and producing a 98% decline in Pinnacle West's net income as compared with 1987.
2. In November 1989, Moody's lowered the ratings on certain APS securities and indicated it will keep APS' securities on credit watch, direction uncertain. Moody's cited, among other factors, the potential for decreasing financial flexibility at APS due to the

continuing liquidity problems of Pinnacle West and Pinnacle West's dependence on common stock dividends.

3. In December 1989, the Federal Office of Thrift Supervision and Pinnacle West entered into an agreement which released Pinnacle West from any continuing obligation to maintain MeraBank's financial soundness in return for Pinnacle West injecting \$300 million in cash into MeraBank, and agreeing to pay MeraBank another \$150 million over a fixed period.
4. In order to borrow the money to bail out MeraBank, Pinnacle West pledged as collateral its only significant asset; 100% of APS's outstanding common stock. Pinnacle West, an exempt intrastate holding company, thus assigned the right to future ownership of a public utility to out-of-state financial interests without any advance notice to the Arizona Corporation Commission or the SEC's holding company regulators.

Throughout all these developments, which were widely reported in the press, the SEC's holding company regulators did nothing. Finally, on May 1 1990, the Arizona Corporation Commission took the unprecedented action of filing a complaint and a petition to revoke or modify Pinnacle West's exemption on the grounds that the exemption had become "detrimental to the public interest or the interest of investors or consumers...." Section 3(a) of the Act. That document brought the entire matter to the SEC's formal attention. Sixteen months later, the SEC still has not acted.

Proposals to weaken PUHCA would permit unlimited diversification at wholesale The corollary to a fully competitive wholesale market is higher risk for the competitors. Under the Johnston proposal utilities would be allowed to roam the country building generators without any review to ensure the financial health of the utility.

- F. Construction Contractors Buying Utility Companies Will Create New Biases In Favor of Risky Construction, and Against Low-Risk Conservation and Load Management

Proposals to weaken PUHCA would permit construction contractors and fuel suppliers to own the very utilities they supply. This type of ownership structure can stifle competition in the market for construction goods and services. Only those contractors wealthy enough to buy stock in new power supply ventures will be able to bid for project work. Other suppliers of engineering and construction services, fuel and financial skills may be more highly skilled; but if they are less wealthy or less well-connected, they will be locked out.

Future opportunities for such abuse will grow if PUHCA is weakened to permit construction contractor ownership without review. Furthermore, providing construction contractors and fuel suppliers with the added incentive to build detracts from efforts to promote low-risk conservation and load management. Any time Congress creates incentive to build new generating capacity, it must recognize that the affect is a disincentive to conserve.

## II. REGULATORY INCENTIVES TO CONSTRUCT UNNEEDED GENERATING CAPACITY DETER ENVIRONMENTALLY SOUND ACTIONS

### A. Market-based Pricing Currently Acts as a Disincentive to Environmentally Beneficial Conservation Programs

Utilities enjoy an exclusive territory with captive customers. The security of this monopoly affords utilities a reasonable opportunity to earn a fair rate of return on their investment. Congress also passed the Federal Power Act, and gave the Federal Energy Regulatory Commission the responsibility to ensure that wholesale rates are just and reasonable

Until recently rates approved by FERC have been based on actual cost. That formula allowed monopolistic utilities to earn a reasonable return on their investment. However, the current trend is for utilities to request and FERC to grant so-called "market-based" rates. In a truly competitive market this trend would be acceptable, as competition would keep rates at cost-based levels. But there are not many truly competitive markets. The zeal with which utilities have sought market-based rates underscores this fact: utilities would not fight for market-based rates if they were not higher than cost-based rates.

Much of the reason a truly competitive market does not exist is that transmission access is controlled by a few large utilities, who grant access on a "voluntary" basis; i.e., when they feel like it. Until Congress passes laws authorizing FERC to require access when necessary for competition, and until a truly competitive market exists, there should be no market-based pricing. Yet as this committee convenes FERC continues to loosen the standards for granting market-based rates. The most recent trend at FERC is to grant market-based rates by letter order, which represents the lowest level of review. 4

While recognizing that FERC's actions do not fall within the jurisdiction of this Committee, the Committee must nevertheless consider the ramifications of market-based pricing

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4 Wallkill Generating Company, L.P., Docket No. ER91-401-000 (July 1991).



which standards. Each type of corporate form should be subject to precisely the same requirements.

**5. Rationalize State and Federal Jurisdiction:** State regulators have the best knowledge of their utilities' supply-side and demand-side options. On the other hand, federal regulation has an advantage over state regulation in that it more objectively seeks out efficient solutions when provincial state goals are in conflict. The following solution tries to steer a consistent path through these principles.

In General: FERC should create competitive conditions in wholesale markets. Thus FERC sets industry guidelines for transmission and power pooling, and reviews specific transmission tariffs. The state's responsibility is to ensure that local distribution companies act prudently in buying from these markets. Thus states regulate utility purchases at wholesale.

Not all wholesale markets will be competitive, even after FERC has ordered transmission access. What if a utility purchase is the least cost purchase, but the price still is too high because competition to sell was weak? In those situations, the state (or a state consumer advocate) should be able to initiate a FERC proceeding concerning the justness and reasonableness of the seller's rate. FERC review in this situation is logical because the likely reason for the excess rate is a flaw in the market, which FERC is best able to correct.

Mississippi Power & Light Situations: A proposal recently agreed to by Entergy, the Arkansas Public Service Commission and the City of New Orleans (which has the regulatory powers of a State commission) would restore much of the State's jurisdiction lost in Mississippi Power & Light. A synopsis of the proposal is attached as Appendix H.

**6. Require Least cost Planning at FERC:** In any wholesale rate proceeding affecting more than one state, FERC may not determine that a sales price was just and reasonable except according to a least cost planning process which assures that the option is the least cost option.

**7. Restrict FERC Departures From Cost-Based Pricing in Wholesale Power and Transmission Transactions:** Deviation from wholesale pricing based on prudent cost should be permitted only upon (1) a precise demonstration that there is a vigorously competitive wholesale market which reliably generates alternatives to the product whose price is at issue, and (2) creation of review process which revisits the market inquiry each year to ensure that any market power remains mitigated.

**8. Limit Investment by Utilities in Nonutility Enterprises:** We should restrict such investment by (1)

identifying types of investment (e.g., "black lung funds" standard now applied to decommissioning funds under IRS rules); (2) requiring advance approval and annual reviews; (3) limiting amounts invested.

9. Confirm the Legal Standing of Retail Customers to Challenge Agency Decisions Adverse to Wholesale Competition: In two recent cases utilities have challenged the legal standing of retail ratepayers to assert an interest in wholesale competition and in corporate restructuring. But if a captive retail ratepayer does not have a direct, economic interest in fully competitive markets, who does? Congress, within the limits of its constitutional authority, must make clear that the beneficiary -- or victim -- of electric utility practices and utility regulation is the consumer.

#### B. Methods for Harnessing the Forces of Competition

1. Prohibit Utilities From Expanding From Their Base as Retail and Transmission Monopolists Unless They Verify That They Will Compete Fairly: Existing utilities are not new entrants in who esale bulk power markets. They are existing players, protected by monopolies over distribution or transmission, hoping to expand their influence. We do not have regulatory tools which reliably can prevent abuse by one entity with two persona ities -- a monopolist and a competitor. We cannot authorize monopoly utility expansion, and then hope those tools develop. Thus far most utilities have not been willing to participate in serious deliberations over regulatory protections. When they do, this question will be worth reviewing.

2. Consider A Carefully Targeted Adjustmant to the "Integration" Requirement of the Act: Some "true independents" argue that PUHCA unnecessarily discourages certain corporate structures that could lead to least cost electricity production. Specifically, they argue that lenders insist that each power project be placed in a separate subsidiary.

These arguments are not consistent with reality. Many companies, such as PacifiCorp and UtiliCorp, do business over large territories without setting up separate subsidiaries. If the true independents' arguments are eventually shown to have factual support, Congress should consider the necessary adjustments to PUHCA. Before doing so however, Congress must learn more about the financing process, to assure that the subsidiary form for true independents is both necessary and efficient.

This relaxation of PUHCA should be a narrow one. True independents do not need exemption from all ongoing financial review. The local economy has a strong interest in the financial viability of electric producers. PUHCA review assures such

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Utilities who benefit from the status quo of transmission control tell Congress that FERC should solve the problems growing out of that control. Then they argue to FERC that Congress has denied them the tools necessary to do so. The positions are not consistent. Again, the Arkansas Public Service Commission:

We agree strongly with those who insist that there cannot be competition or least-cost planning unless all competitors have fair access to essential transmission facilities. Arkansas cannot institute least cost planning if the least-cost generators are barred from transmission by higher cost competitors. Effective least-cost planning requires fair competition.

C. Regulation by FERC, and Residual Regulation by SEC, Will not be Sufficient to Protect Consumers or Competition

FERC's "Market-Based Pricing" Cannot Protect Consumers in the Absence of PUHCA's Structural Protections: As discussed above, FERC has begun to abandon cost-based competitive pricing in favor of "market based pricing even where no fair market is guaranteed. In its most extreme manifestation, FERC reasoning allows a new producer to build generation on the grounds that the price of the new generation is less than the utility's "avoided cost;" that is, the cost of other alternatives which the utility would otherwise pursue.

In none of these cases has FERC determined whether the avoided cost is a prudent avoided cost. In particular, FERC has disregarded conservation and load management as an alternative measures of avoided cost. In one case, all the Commission required was a certificate from the buyer, saying that the sales price did not exceed avoided cost. This "regulation-by-certification," without a proper market analysis, is not consumer-protective regulation.<sup>8</sup> Repealing PUHCA's structural protections in reliance on FERC's transactional protections is not good policy.

SEC and Pre-Acquisition Review: Recent SEC interpretations of its pre-acquisition review duties have left consumers at risk of utility corporate structures that encourage inefficiencies, forum-shopping, consumer abuse and anticompetitive behavior. We cannot rely on the SEC's holding company regulators to administer

<sup>8</sup> See Citizens Power & Light Corporation, 48 F.E.R.C. para. 61,120 (1989). Contrast Baltimore Gas & Electric, 40 F.E.R.C. para. 61,170 at p. 61,538 (1987), where each avoided cost rate permitted by the Commission was a rate which the Commission previously had determined to be just and reasonable.

Commissioner Russell concluded that "[t]his situation can only get worse if revisions to the Holding Company Act encourage all of our electric utilities to emulate Consumers Power Company." He then stated (id.):

... Creating exempt wholesale generator will not in and of itself stimulate a truly competitive market. Regulated utilities are the primary customers of the would-be wholesale generators. As long as they retain both the exclusive control of the national transmission system -- and the ability to opt out of the competitive marketplace -- utilities will retain all of the advantages that their monopoly positions give them plus they will gain new opportunities for configuring themselves to extract monopoly profits from their customers.

Similarly, the Arkansas Public Service Commission has stated:

We are not certain of Entergy's goals. Because of our uncertainty concerning Entergy's goals, we need certainty concerning state regulatory jurisdiction, as well as the regulatory backstop furnished by Public Utility Holding Company Act. 7

**B. "Voluntary" Transmission Access Will Not Protect Against Abuse Of Competition**

Many utilities point to various "voluntary" transmission access proposals by utilities as a sign that the industry is moving to a transmission access regime without regulatory or legislative mandate. But "voluntary" access is voluntary for the "haves;" involuntary for the "have nots." Under "voluntary" access, the transmission monopolist provides service when it wants to; not when others need it.

Utilities' interest in "voluntary" access likely will last no longer than their excess generating capacity. Utilities like Public Service of Indiana have excess generating capacity that they wish to market at purportedly "flexible" prices. In order to win FERC approval of prices that depart from cost (i.e., prices which can produce extraordinary rates of return), these utilities must offer transmission access to those who otherwise would be forced to buy this high-priced power. When there is less generation excess, there will be less transmission access.

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7 Testimony before U.S. Senate Committee on Energy and Natural Resources (Mar. 14, 1991).

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what remains of the Act responsibly. 7 Appendix C explains this problem in more detail.

**Utility Mergers Generally:** Together, the merger and acquisition provisions of the Federal Power Act and the Public Utility Holding Company Act should produce an electric industry which is locally managed and locally regulated. Utilities should be focusing on their core customers, providing the type of energy service most consistent with the customers' needs.

Utility actions over the past few years have scattered these principles to the four winds. Witness the following:

- a. Utilities acquire other utilities, make the acquirees divisions rather than subsidiaries, and thereby escape review under PUHCA completely.
- b. Utility and others acquire wholesale generating companies in remote locations using a limited partnership form rather than a new corporation, and similarly escape PUHCA. Southern California Edison and Mitsubishi are prime examples of this distant management.
- c. After FERC's decision in the recent Missouri Basin case, utilities who form holding companies, and then merge, escape the Federal Power Act completely. 8

The consequences of FERC's Missouri Basin decision are dramatic. Where FERC has jurisdiction over mergers, FERC has insisted that the merger not weaken competition; if it does, FERC insists on transmission access. But where FERC has no jurisdiction over the merger, FERC cannot protect against anticompetitive consequences.

More generally, merger law as applied by FERC fails to distinguish between efficient mergers and inefficient mergers. Normally, we expect management to act to minimize costs for ratepayers. But management of a target company will refuse even

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7 A more detailed treatment of inadequate SEC enforcement appears in my article, "Corporate Restructuring and Consumer Risk: Is the SEC Enforcing the Public Utility Holding Company Act?" The Electricity Journal (July 1988).

8 See Missouri Basin Municipal Power Agency v. Midwest Energy Co. and Iowa Resources Inc., FERC Docket No. EL90-31-000, Order Noting and Granting Interventions and Dismissing Complaint, Dec. 13, 1990. See also D. Allen, "To FERC or Not to FERC, That Is the Question" The Electricity Journal 62-65 (January/February 1991).



efficient mergers until they obtain the highest possible price for the shareholders. That high price, if paid by the acquirer in the form of an acquisition premium, can burden ratepayers. 9

**D. Creation of Leveraged Affiliates is not Necessary to Produce the Benefits of Competition**

Some utilities argue that they should create affiliates because affiliates can use "leveraged" capital structures that produce lower costs. A leveraged structure has higher ratio of debt to equity than normal. Since debt costs less than equity, the argument goes, costs are lower. This argument does not stand up.

Leveraging is not a free lunch. The higher the debt ratio, the greater the fears of investors -- both stockholders and bondholders -- that the entity lacks sufficient assets to pay dividends consistently, or retire the debt principle, during times of economic downturn. Owners of securities in the buying utility will be concerned that if the affiliate encounters financial difficulty, the holding company parent will shift assets or funds from the utility to the affiliate, thereby weakening the utility. The utility's equity owners will demand some protection for that risk, in the form of higher returns. The money for those higher returns comes from captive ratepayers.

If leveraging were indisputably beneficial to consumers, utilities would leverage, and there would be no justification for the affiliate. But many states and their regulators are risk adverse, and do not want the utility to leverage. Under these circumstances, a utility who proceeds to create a leveraged

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9 Regulatory policy on the acquisition premium does not steer a clear path through these issues. Thirty years ago, the Commission asserted that it would permit an acquisition adjustment only if consumer benefits were (1) clearly traceable to the acquisition, and (2) not achievable without the acquisition. Gulf Energy & Development Corporation, 4 F.E.R.C. para 61,080 at p. 61,173 (1978). Assuming these first two tests were met, the Commission then would limit the amount of the adjustment to the dollar level specifically quantified by the acquirer.

However, in a 1988 decision, the Commission applied a more relaxed standard, considering only whether the acquisition was "prudent." Minnesota Power & Light Company and Northern States Power Company, 43 F.E.R.C. para. 61,103 (1988). The Commission did not insist on any (a) quantification, (b) tracing of benefits to the acquisition, (c) a showing that benefits would not have been achieved without the acquisition, or (d) a limit of the acquisition adjustment to the level of benefits shown.

affiliate and then buy power from that affiliate is simply circumventing the state's policy against leveraging.

**E. Proposals to Weaken PUHCA Make No Distinction Between the Adjustments Entrants (1) Want and (2) Need**

Proponents of proposals to weaken PUHCA make no distinction between the changes they want and the changes they need. More specifically, they fail to distinguish between barriers and burdens.

In the case of true independents and traditional utilities, the only possible barrier to entry is the "integration" aspect of Section 10(c)(2). Under that requirement, a holding company may not own more than one utility corporation unless all the utility assets operate together as a single integrated, coordinated system. Under the Act, a holding company may not own a utility subsidiary in Maine and a utility subsidiary in California; the two utilities never could act as a single coordinated system.

The barrier, if there is one, exists only if the utility chooses a corporate structure which places each project in a separate subsidiary. Is this choice necessary? Some say, "Wall Street requires it." Those who seek radical changes to the Act certainly must do more than say that "Wall Street" requires those changes. As Appendix F explains, utilities with skills to spare can spin off new companies rather than create affiliates.

Even if Congress does eliminate the integration requirement of Section 10(c)(2), it need not relax the improvement requirement. The improvement requirement is necessary to ensure that a single holding company does not merely expand for the sake of expansion; but that it expands because expansion improves the lot of ratepayers.

**F. It is Virtually Impossible to Impose Real Risk on Wholesale Generators As Long As Distribution Customers are Captive**

Utilities argue that their IPPs will bear risks of generator construction. IPP supporters contrast the 1970s' "cost plus" construction in which ratepayers bore the risk of all cost increases.

To expect all risks to sit with the risktakers in an industry of captive customers is to ask the impossible. The industry has not worked that way.

1. Public Service of New Hampshire's investors took the risk of building a nuclear plant. When PSNH failed, the costs fell only partially on PSNH shareholders and creditors. A significant share of the cost -- hundreds

of millions of dollars -- fell on PSNH's captive ratepayers, as well as other ratepayers in New England (who, under the NU-PSNH merger proposal, must forfeit existing coordination savings for the benefit of the merged company).

2. When Consumers Power's Midland Nuclear plant failed, taking the company near bankruptcy, the company sought and received "financial stabilization rates": above-cost rates that never could be sustained in a competitive market. The savings and loan industry provides another example of transfer of risk. In that industry, the captives taxpayers were forced to cover the bets that investors took. In the utility industry the captives are, and always will be, the ratepayers.

We all desire competitive wholesale markets. But retail markets are not competitive. They are controlled franchised monopolists and their customers are captive. Competition means winners and losers. If utilities are going to venture into competitive wholesale markets, there must be some means of protecting their captives from loss.

#### V. UTILITIES OPPOSING COMPETITION SHOULD BE IGNORED

Posing as allies of the consumer, some utilities have attacked truly independent power producers as "unreliable." <sup>10</sup> These utilities are in no position to criticize. Their overinvestment in billions of dollars in baseload generation in the 1970s has been criticized by every objective observer, including Forbes magazine (Feb. 11, 1985).

These utilities respond that state regulators did not uphold the so-called "regulatory compact." By "regulatory compact," they mean their expectation that shareholders are protected from market risks. There is no such compact. The U.S. Supreme Court has rejected a claim that utility shareholders some "compact" grants a constitutional right to a return. Duquesne Light Company v. Barasch, 488 U.S. 299 (1989).

These utilities also claim no aversion to competition. As Mr. Jordan wrote (id. at 28.), "we have always dealt squarely with the forces of the marketplace." When? This industry, including Mr. Jordan's company, has resisted granting fair access to the transmission highways on economic terms. Moreover, every fuel source used by this industry -- coal, gas, oil and nuclear -- is subsidized by someone: another region may pay for

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<sup>10</sup> See, e.g., D. Jordan, "The Hidden Threat," Public Utilities Fortnightly at 27, (Mar. 15, 1991).

spillage, a future generation may pay for pollution clean up, federal taxpayers may support research and development, and everyone may support the cost of a nuclear accident in excess of the ceilings stated in the Price-Anderson Act. We do not have competition in the industry today.

Finally, these utilities also argue that independent generators are less reliable than traditional utilities because the independents are bound by contracts only, not franchises. That is circular reasoning. We can bind wholesale generating entities to a franchise obligation just as we bind distribution utilities.

#### CONCLUSION

Proposals to weaken PUHCA constitute the most dramatic weakening of electric utility regulation since the 1920s. They authorize entry to everyone, small and large, with and without market power, and simultaneously remove crucial consumer protections.

I appreciate this opportunity to present my views.

## APPENDICES

APPENDIX A  
EXPLANATION OF ABUSIVE UTILITY-AFFILIATE RELATIONS

Assume a new low-cost generation opportunity appears within a utility's service territory. The parent utility with the retail monopoly should exploit this opportunity for its customers. Instead, if the parent utility has an affiliate it will channel this opportunity to its affiliate. The affiliate then will produce the low-cost power and sell to the parent utility at the parent's higher avoided cost. The captive retail customers then pay a marked-up price. In effect, the utility has diverted savings from captive customers to shareholders.

The utility also has violated principles of fair competition. In a free market, competition would push the retail price down to the level of the most efficient seller's production cost. But in the case of a franchised utility, where there is no competition at retail, the price remains at the utility's avoided cost. The difference is monopoly rent.

This type of abuse is a relatively recent phenomenon. Until 1978, a utility could not create or acquire more than one such affiliate without first satisfying the "advance review" tests of the Act. These tests effectively barred a utility from creating an affiliate to supply power that the utility could supply itself. 11

In 1978, this statutory scheme changed dramatically. Under the Public Utility Regulatory Policies Act of 1978 ("PURPA"), a traditional utility now may create or acquire an unlimited number of generating utilities without satisfying the advance review tests of PURCA, provided the generating utilities are "qualifying facilities" under PURPA. The transactions between utilities and their affiliates, nonreviewable by the SEC under PURCA, have engendered much controversy. The problem was summarized aptly by the Michigan Public Service Commission when it described last summer an interaffiliate contract involving Consumers Power:

One must wonder whether Consumers has once again negotiated with itself and lost.

U-8871, Order of June 22, 1989 at 31.

An Appendix to my testimony presented to the Senate Committee of Energy and Natural Resources in November 1989

11 Sections 9 and 10 of PURCA, 15 U.S.C. sec. 79i and 79j, required the utility to make an affirmative showing to the U.S. Securities and Exchange Commission ("SEC") that the acquisition would produce economies and efficiencies for the utility's ratepayers by "integrating" the acquired assets with the utility's existing assets, (2) would not create the potential for anticompetitive behavior, and (3) would not result in corporate structures that complicate state regulation.

contained case studies of utility affiliate problems involving Southern California Edison, Consumers Power, Florida Power Corporation, Tucson Electric Power, Sierra Pacific Power, Ohio Power, Columbia Gas System, Arizona Public Service, Niagara Mohawk Power Corporation, Central Illinois Public Service Company, Montana-Dakota Utility Company, and Public Service Company of New Mexico. These case studies reveal the following abuses, among many others:

1. Utility pays excess capacity charges to its affiliate.
2. Utility pays the salary of the affiliate's negotiating team.
3. Utility imposes onerous contract terms on nonaffiliates but not on affiliate.
4. Utility buys gas at two different rates; assigns high-cost gas to itself and low-cost gas to its affiliate.
5. Utility grants transmission access to its affiliate but denies it to unaffiliated competitors.
6. Utility pays prices to its coal subsidiary in excess of market prices.
7. Utility ships its coal over its transportation affiliate's rail lines for a price exceeding that of alternative rail lines.
8. Utility obligates itself to buy more capacity from its affiliate than it needs.
9. Utility affiliate's business risks inflate the cost of capital for the utility.
10. Utility hires its affiliate to act as sales broker to sell utility land to the affiliate.

APPENDIX B  
DENIALS AND DISCRIMINATION IN TRANSMISSION ACCESS

Otter Tail Power Company

In Otter Tail Power Co. v. United States, 410 U.S. 366 (1972), the U.S. Supreme Court ruled that Otter Tail engaged in anticompetitive practices designed to prevent towns from establishing their own municipal systems. Among its findings, the Court stated that Otter Tail's refusal to wheel power to its municipals constituted illegal monopolization, which foreclosed potential entrants in the retail area from obtaining electric power from outside sources of supply.

Even after the Supreme Court ruling Otter Tail continued to erect transmission obstacles, in spite of the fact that its earlier predictions of system erosion and increasing rates for its remaining customers proved to be unfounded. In fact, Otter Tail's revenues increased from \$34.46 million in 1970 to \$175 million in 1988.

Southeastern Power Administration v. Kentucky Utilities Company

Beginning in 1974, the Southeastern Power Administration (SEPA) began negotiations with Kentucky Utilities Company (KU) concerning wheeling 25 MW of federal preference power to eight municipal utilities (seven of which were full requirement customers of KU). SEPA planned to sell the municipals the power from its Laurel hydroelectric project, but after 1977 sold that power elsewhere because neither SEPA nor the municipals could arrange for wheeling.

In 1979 SEPA and the municipals filed a request with FERC asking it to order KU to wheel, and in 1981 FERC denied this request. Also in 1981 the Department of Justice filed an antitrust violation suit against KU concerning its tactics toward SEPA and the municipals (DOJ ultimately dropped the suit). In 1983 SEPA filed with FERC again. This time FERC ruled that it could not order KU to wheel because such an order would not preserve existing competitive relationships as required by the Federal Power Act (see FPA section 211 (c)(1)).

Southern California Edison Company

Five California cities filed an antitrust suit against Southern California Edison (SCE) in 1978, claiming that SCE effected a price squeeze and denied the cities access to lower cost alternative energy on the Pacific Intertie. SCE has continuously stonewalled the cities' efforts to obtain access to cheaper power by offering only interruptible transmission service

and ensuring that capacity on the Intertie would rarely be available. Moreover, SCE rejected the cities' proposal to assist in upgrading the Intertie in order to increase its capacity.

Perhaps the most alarming aspect of this situation is the cities' discovery that in instances when SCE has curtailed a city's import, it has contacted the supplier and purchased the available energy in the city's stead. Effectively SCE has prevented the municipal utility from taking advantage of a low cost opportunity, purchased the power itself - and then turned around and sold it to the municipal utility at higher rates.

The parties tried this case in 1986 before the U.S. District Court, and in November 1990 the court finally issued a ruling against the cities. The cities have appealed to the U.S. Court of Appeals for the Ninth Circuit.

#### Tampa Electric Company

On September 3 1986, W.R. Grace & Co. filed a petition with the Florida PSC requesting a declaratory statement requiring TECO to provide transmission access which would allow Grace to wheel power from its cogenerating facility at a chemical plant to its mining operation eleven miles away. Under the rule at issue, the PSC can only order this type of self-service wheeling where provision of the transmission service would not result in higher costs to the utility's ratepayers and would not adversely affect system reliability.

The PSC denied Grace's request on the ground that wheeling would likely result in higher cost to TECO's ratepayers but noted that TECO's refusal to wheel could be subject to prudence review based on Grace's stated intention to construct its own transmission line and TECO's duty to take action to minimize the adverse impact of revenue loss (which would emanate from Grace's lost fees from not using TECO's transmission lines).

#### Public Service Company of Colorado

Federal legislation gives designated customers preference to federally generated hydroelectric power. Starting in 1985 three federal executive agencies (FEAs) in Colorado attempted to purchase such power from the Western Area Power Administration (WAPA), however the purchase agreement was contingent on the agencies securing transmission access.

For an extensive period of time the FEAs attempted to negotiate agreements with Public Service Company of Colorado (PSCO) to wheel the WAPA power. PSCO refused to wheel, claiming that it would cause an increase in rates to other PSCO customers,



despite the fact that PSCO supplemented its own generating capacity with firm power purchases (PSCO could have stopped the power purchases and sold transmission access to the agencies, thereby lowering rates).

On April 14, 1986 the agencies filed a complaint with the Colorado PUC requesting a wheeling order. However, the PUC dismissed the complaint on the grounds that the Commerce Clause barred it from ordering wheeling, and on March 7, 1988 PSCO filed an appeal in a Colorado state court (can we be more specific ?).

#### Southern California Edison - San Diego Gas & Electric

During the recent FERC hearings on the proposed Southern California Edison (SCE) takeover of San Diego Gas & Electric (SDG&E), a FERC staff witness testified that SCE has frequently denied transmission service for economic reasons. In one instance SCE denied SDG&E north-bound transmission from a jointly owned nuclear plant, due to an alleged lack of available capacity, despite an internal memo which indicated the availability of such capacity. In another instance, SCE offered its municipal "resale" cities firm transmission service only if they purchased a firm share of the San Onofre Nuclear Generating Station power.

Another instance of SCE manipulation concerning transmission service presented itself during state level proceedings on the merger. A witness from SDG&E testified that SCE arranged a transmission swap with the Los Angeles Department of Water and Power (LADWP) in order to squelch LADWP interest in another transmission project which would allow various other smaller transmission dependent utilities to avoid purchasing transmission access from SCE.

#### New York State Electric & Gas Corporation

In a case involving transmission of preference power from the Power Authority of the State Of New York (PASNY) by New York State Electric & Gas Corporation (NYSEG), FERC found restrictive provisions in the contracts to be unreasonably anticompetitive. FERC upheld complaints by the village of Penn Yan, N.Y., that restrictions in the contract limited the use of the power within the village boundaries thereby restricting Penn Yan's ability to extend its municipal system.

The U.S. Court of Appeals for the Second Circuit ruled that FERC's opinion amounted to a motion to compel wheeling, thus requiring a hearing under Federal Power Act sections 211 and 212. The court remanded the case to FERC. Penn Yan, FERC, and the

Department of Justice filed a petition for rehearing at the Court of Appeals which the court later denied.

#### Florida Power and Light

In Florida, Florida Power and Light (FP&L) refuses to file a transmission tariff and will deal only on a contract-by-contract basis. This policy leaves municipal systems dependent on transmission by FP&L unable to take advantage of economical short-term transactions with other utilities, as by the time negotiations can be concluded, the opportunity is gone.

#### American Electric Power Corporation

The giant American Electric Power Corporation forces other utilities dependent on its monopoly ownership of transmission to forego short-term and opportunity sales and purchases. AEP has refused to sell transmission service in less than 12-month time segments, and imposes unreasonable notice requirements on utilities requesting transmission. The upshot is that AEP acquires a competitive advantage over other generating utilities through its control of the transmission system.

#### Carolina Power and Light, Duke Power, and Virginia Electric and Power Company

Carolina Power and Light requires an eight year notice before it will wheel power from alternate suppliers to a municipal customer on its system, unless that power is preference federal hydro power. Duke Power has a similar constraint for those municipal-cooperative customers buying power from the Catumba Nuclear plant. Virginia Power similarly restricts those wholesale customers who participate as owners in the North Anna nuclear units from access to supplemental purchases.

#### City of Manti, Utah v. Utah Power & Light Co.

In the wake of Utah Power & Light's (UP&L) decision to terminate wholesale power service to the city of Manti, the city filed an application with FERC requesting transmission service on a long-term basis. Manti had arranged alternative sources of power to replace UP&L, but could not finalize the agreement until UP&L guaranteed transmission access. UP&L stonewalled Manti for eleven months (Jan. '86 to Nov. '86) claiming that it needed additional information, and during this time filed a motion with FERC to dismiss the application. Only after FERC dismissed UP&L's motion, did Manti and UP&L reach an agreement.

C. The SEC Has Disregarded the "No Concentration of Control" Requirement of Section 10(b)(1)

Section 10(b)(1) of the Act requires the Commission to disapprove any holding company acquisition which "tend[s] towards ... the concentration of control of public-utility companies, of a kind or to an extent detrimental to the public interest or the interest of investors or consumers." The Commission's analyses of the anti-competitive risks of recent holding company acquisitions bear little resemblance to rational antitrust analysis.

One example is Northeast Utilities' acquisition of Public Service of New Hampshire, Admin. Proc. 70-7695 (December 21, 1990). The Commission held that acquisitions were per se not anticompetitive because the post-acquisition entity was smaller than other holding companies in the nation. There was no analysis of relevant product market, relevant geographic market, concentration ratios or indices, or any of the other conventional or reliable factors used in antitrust analysis. The Commission essentially found that a merger would not dominate Market X because the merged company was smaller than companies in Market Y. No statute, court, agency, or commentator, in the history of antitrust law has ever analyzed a question of competition in this manner.

E. The Commission's Decisionmaking Procedures are Biased Against Consumers and Inconsistent with Administrative Fairness

Proper enforcement requires not only adequate staffing, but procedures which ensure public participation and review. In this regard, the SEC's procedures are faulty, in several ways. The first example concerns utility proposals which trigger a notice in the Federal Register and an opportunity for public comment. In those cases, utility officials commonly meet with the SEC staff in advance of the notice to iron out details in private. Then when consumers file protests pursuant to the Federal Register notice, the very same staff advises the Commission to reject the consumers' concerns. This procedure is inconsistent with administrative fairness.

In numerous other cases, no Federal Register notice is triggered whatsoever. Instead, the utility and the staff meet privately, and agree on a corporate structure that does not, in the staff's view, implicate a specific provision of the statute. The staff then sends the utility a so-called "no-action" letter, stating the staff's expectation that it will take no action to oppose the proposal. The public has no opportunity to comment on whether the Act is implicated, and does not even learn about the utility transaction until afterwards, if at all. I am aware of

APPENDIX C  
FLAWS IN THE SEC'S REGULATION UNDER PUHCA

A. The Boundaries of PUHCA's "Intrastate" Exemption Evaporate Whenever An Interstate Electric Company "Transfers Title to Electrons" Within the State of Generation

The SEC has deemed "intrastate" a holding company structure with explicit plans to sell interstate. In the Sierra Pacific Resources case discussed previously the construction consortium planned to sell electricity at wholesale to customers throughout the Western U.S. The Commission found that the consortium would be intrastate because the interstate contracts would be drafted so as to "transfer title to the electrons" at the plant site in Nevada. The notion that electrons are goods that are selected, owned, and transferred in identifiable lots has no basis in the law of PUHCA or the law of physics.

B. The SEC Has Disregarded the "Efficiencies and Economies" Requirement of Section 10(c)(2)

Section 10(c)(2) of PUHCA restricts holding company acquisitions to those which might bring actual operational benefits to its component parts from related operations and unified management.<sup>1</sup> On at least three occasions, the SEC has approved a type of restructuring where a shell corporation acquired the stock of an existing utility system while making no change in the operations of utility assets. The third decision, involving Wisconsin Power & Light, was challenged in court by a consumer group I represented on the ground (among other grounds) that because the restructuring made no improvement in utility operations (WP&L had admitted as much), it could not satisfy Section 10(c)(2). In August 1989, the U.S. Court of Appeals for the D.C. Circuit found that the SEC approval violated Section 10(c)(2). Wisconsin's Environmental Decade v. SEC, 882 F.2d 523 (D.C. Cir. 1989).<sup>2</sup>

<sup>1</sup> See, e.g., Electric Energy, Inc., 38 S.E.C. 658, 670-71 (1958) (Commission's approval rested on findings that the acquisition led to creation of an "operating committee" to "effectuate the efficient coordination of the generating facilities of [the to-be-acquired utility] with the generation transmission and distribution systems" of the acquiring utilities; use of new microwave communication links to coordinate pre-planned power transfers among the new plant and the existing utilities; enhancement of the existing "power pool" relationship among three of the four acquiring utilities).

<sup>2</sup> The Court remanded the matter to the SEC, and the parties now are disputing what type of improvements are necessary to satisfy the statute. The company continues to assert that no change in the operation of utility assets is necessary.

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no procedure by which consumer representatives, state regulators, or competitors may protest such action.

#### APPENDIX D "RECIPROCAL DEALING"

"Self-dealing" should be defined to include "reciprocal dealing." Assume a Virginia utility creates an affiliate that sells to a California utility. Assume further that the California utility creates an affiliate to sell to the Virginia utility. Finally, assume that each affiliate is producing at a cost below its affiliated utility's cost. In these transactions, both utilities may be overpaying for power, if each buying utility could have produced power itself at a lower cost than the purchase price.

Regulating cross-country reciprocal dealing will be difficult. In the example above, regulators must protect the interests of captive customers in Virginia, captive customers in California, competition in Virginia and competition in California. No current regulatory law was enacted with that type of transaction in mind.

The most reliable solution to reciprocal dealing may be the same as the solution to self-dealing: prohibit it.

#### APPENDIX E RECONCILING "NATIVE LOAD" WITH FAIR COMPETITION

Some utilities oppose transmission access by arguing that their native load customers have a right to preferential use of the facilities for which they have paid. This argument inflates a transitional dispute into a permanent distortion of wholesale markets.

To the extent the native load customers have already paid for facilities, they are entitled to some type of preference. But that preference should be no larger and last no longer, than necessary to compensate the native load for costs incurred. Existing capacity will not last forever. Over the long term, all prospective users should have an equal right to use all facilities provided they pay their fair share. To avoid perpetuating the native load preference, everyone must have an equal right to "pay for" whatever they need to compete evenhandedly in bulk power markets. This principle means that owners of monopoly transmission facilities must take into account the needs of non-native load ratepayers.

During the transition period, native load customers of the transmission monopolist have no legitimate expectation of monopoly compensation. Nor do these customers have a right to

assign the incremental cost of all transmission expansions to transmission customers. On an integrated network, all facilities benefit all users. Therefore, all customers should share in the costs of all facilities. To force newcomers alone to bear the cost of new facilities is to create a monopolist's distinction, which could not be sustained in a competitive market.

#### APPENDIX F

##### UTILITIES WITH SKILLS TO SPARE CAN SPIN OFF NEW COMPANIES RATHER THAN CREATE AFFILIATES

Some argue that utilities should be free to expand so that they can export their experience and skill to new regions. This argument is wrong. If an existing utility has management to spare, it need not expand to new territories. It can transfer that management to a new company and spin off that company to its shareholders. In this way, other regions will receive the benefits of the excess skills and assets. There is no public interest reason why the pre-existing utility need retain control of the new company.

The only argument against the spin-off option is that the original utility could not itself profit from these new ventures. That is precisely the point. The utility cannot serve two sets of customers, one captive and one competitive, without creating risks of abuse that currently are insoluble.

#### APPENDIX G

##### MODEL LEGISLATION ON PUHCA AMENDMENT

The following legislation offers the protection necessary to ensure a truly competitive market. PUHCA exemptions would be available only after FERC deems such exemption to be in the public interest, on a case-by-case basis. The applicant would obtain the PUHCA exemption and FERC price approval in one proceeding. FERC would analyze the distinct benefits and risks of each project on a case-by-case basis. Exemption would be conditioned on the wholesale power supply contract being pro-competitive, protective of consumers, and consistent with state requirements.

Two specific features of the legislation lacking in the Johnston Bill are Section 9 which guarantees fair transmission access to all IPPs and Section 6 which prohibits self-dealing. Additionally, Section 5 sets out requirements regarding registered holding companies and the protection of states rights to participate in integrated resource planning.

SECTION 1.	SHORT TITLE.
SECTION 2.	FINDINGS AND PURPOSE.
SECTION 3.	DEFINITIONS
SECTION 4.	EXEMPTIONS FROM THE HOLDING COMPANY ACT
SECTION 5.	EXEMPTION REQUIREMENTS FOR POWER PRODUCER SALES.
SECTION 6:	REQUIREMENTS APPLICABLE TO UTILITIES AND UTILITY AFFILIATES
SECTION 7:	OTHER REQUIREMENTS RELATED TO EXEMPT POWER PRODUCERS
SECTION 8:	ALTERNATIVE OWNERSHIP STRUCTURES
SECTION 9:	FAIR TRANSMISSION ACCESS
SECTION 10:	JURISDICTION OF OFFENSES: ENFORCEMENT OF LIABILITIES AND DUTIES

### SECTION 3. DEFINITIONS.

As used in this Act--

(a) **RETAIL UTILITY.**--The term "retail utility" means any person having the right under State law to sell electricity at retail to consumers.

(b) **POWER PRODUCER.**--The term "power producer" means any person, other than a public utility holding company, which is engaged exclusively in the business of owning or operating one or more eligible facilities as defined by this Title.

(c) **AFFILIATE POWER PRODUCER.**--The term "affiliate power producer" means a power producer that is an affiliate or associate company of a retail utility company.

(d) **EXEMPT POWER PRODUCER.**--The term "exempt power producer" means a power producer or affiliate power producer that qualifies for and has obtained an exemption under this Title from one of more provisions of the Act.

(e) **ELIGIBLE FACILITY.**--(1) The term "eligible facility" means a facility that generates electric energy for sale at wholesale (which facility may include interconnecting



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transmission facilities necessary to effect such sale at wholesale), provided that if the electricity produced from such facility is sold, directly or indirectly, within the United States, all electricity generated by such facility is sold under a power purchase agreement or agreements approved pursuant to the requirements of section 5; and provided further, that sales of a small amount of electricity from a facility to a geographically proximate ultimate consumer that is integral to the operation of such facility, including an essential supplier of such facility, shall not preclude such facility from eligibility if such sale is not in violation of State law.

(2) If at any time there is in effect a rate or charge for, or in connection with, the construction or lease of a facility, or for the purchase or sale of electric energy generated by the facility, that facility may not become an eligible facility for purposes of this Act unless

(A) each State commission having jurisdiction over such rate or charge consents to the facility becoming an eligible facility;

(B) the Commission has found that the owner of such facility satisfies the requirements of sections 4, 5 and 6, where applicable; and

(C) the Securities and Exchange Commission has approved any change in ownership of such facility under

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Page 3

any applicable provision of the Public Utility Holding Company Act.

(f) **PURCHASING UTILITY.**--The term "purchasing utility" means a public utility that executes a power purchase agreement with a power producer, or that otherwise, directly or indirectly, purchases electric power or energy from that power producer.

(g) **AFFILIATE.**--The term "affiliate" has the same definition as in the Public Utility Holding Company Act; provided that an exempt power producer shall be deemed to be an affiliate of a retail utility if, at any time, before or after the exempt power producer commences commercial operation of an eligible facility, the retail utility, directly or indirectly, owns or influences, is owned by, or is subject to common ownership or influence with, such exempt power producer or such exempt power producer's successor or predecessor. For purposes of this paragraph --

(1) "ownership" means 5 per centum ownership of any corporate or partnership interest, regardless of whether such interest is a voting or a nonvoting interest; and

(2) "influence" means having the potential to affect any decision of the affiliate which decision will have a material effect on costs, revenues or competitive behavior or position.

(h) **STATE COMMISSION.**--The term "State commission" has the meaning provided by section 3(14) of the Federal Power Act.

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(i) COMMISSION.--The term "Commission" means the Federal Energy Regulatory Commission.

(j) ACT.--The term "Act" means the Public Utility Holding Company Act, 15 U.S.C. sec. 79, et seq.

(k) INTEGRATED RESOURCE PLAN.--The term "integrated resource plan" means a least cost energy conservation and electric power plan which evaluates all reasonably available resources, including new power supplies, energy conservation, and renewable resources, in order to meet expected future demand.

(l) COMPETITIVE PROCUREMENT PROCESS.--The term "competitive procurement process" means a process ensuring that all persons wishing to provide generation or non-generation services have a reasonable opportunity to do so.

(m) MUNICIPALITY.--The term "municipality" has the meaning set forth in Section 3(7) of the Federal Power Act.

(n) AFFECTED STATE COMMISSION--Any State commission with authority to regulate the retail rates of a retail utility purchasing (directly or indirectly) from, or affiliated with, an exempt power producer.

(o) OTHER TERMS.--Except as otherwise defined in this section, all terms used in this Title have the meaning provided by section 2(a) of the Holding Company Act.

SECTION 4. EXEMPTIONS FROM THE HOLDING COMPANY ACT--(a)  
Application for Exemption. Upon application by any person

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Page 5

seeking to become an exempt power producer or affiliate thereof, the Commission may by order exempt the applicant from any provision of the Act if the Commission finds, after notice and opportunity for hearing on such application, that

(1) exemption from such provision will advance the public interest and the interest of consumers;

(2) the power producer has entered into a power purchase agreement that satisfies the requirements of section 5; and

(3) if the applicant is an affiliate power producer, the applicant has satisfied any applicable requirements of section 6.

(b) An applicant under subsection (a) of this section that is or will become a power producer or an affiliate of a power producer, by acquiring an interest in an eligible facility or a power producer, shall be eligible for exemption from only those provisions of the Act that otherwise would apply by reason of such acquisition.

(c) Implementation: Within 180 days of enactment of this title, the Commission shall promulgate rules implementing application procedures for exemption.

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SECTION 5. EXEMPTION REQUIREMENTS FOR POWER PRODUCER SALES.--

The Commission shall not approve any rates, terms or conditions of a sale of electric energy subject to its jurisdiction by a power producer seeking to obtain or maintain an exemption under section 4, unless the requirements of subsections (a) through (c) are satisfied.

(a) Review by Commission: The Commission has found that

(1) the rates, terms and conditions of the power sales agreement are just, reasonable and not unduly discriminatory or preferential under Sections 205 or 206 of the Federal Power Act (16 U.S.C. 824c and 824d), provided that an agreement will not satisfy this requirement unless

(A) it was entered into as part of a competitive procurement process in which the seller faced effective competition or

(B) its rates do not exceed the seller's cost of service, including a reasonable return on prudent investment;

(2) no person or municipality otherwise able to sell electricity to the purchasing utility has been unable to compete to sell electricity to the purchasing utility or municipalities or persons for resale because of the purchasing utility's failure to provide such entity nondiscriminatory transmission access;

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(3) no person or municipality interconnected with the purchasing utility that is otherwise able to purchase electricity from the power producer for resale has been unable to compete to make the purchase because of the purchasing utility's failure to provide such entity nondiscriminatory transmission access; and

(4) the power sales agreement is not prohibited by section 6 of this Title.

(b) Opportunity for Review by Affected State Commissions:

No affected State commission (other than a State commission covered by subsection (c)) has found that

(1) the power sales agreement was entered into through a process inconsistent with any applicable competitive procurement process;

(2) the purchase is inconsistent with any applicable integrated resource plan;

(3) the power producer is incapable of performing its obligations under the power sales contract, or has affiliations which impose an undue risk that the power producer will not be able to perform such obligations; or

(4) such State commission lacks access to the books and records of the retail utility subject to its jurisdiction, or any affiliates thereof, or of the power producer, to the extent necessary to protect against the risks set forth in clause (3).

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(c) Review of Registered Holding Companies: Where the purchase is made by an operating subsidiary of registered holding company for the benefit of the holding company system, subsection (b) will be satisfied if none of the findings set forth in subsections (b)(1) through (b)(4) have been made --

(1) where there is an approved regional integrated resource plan, by an authorized regional board or, in the absence of such board, by the Commission;

(2) where there is no approved regional integrated resource plan, by the Commission.

(d) Implementing Regulations: Not later than 180 days after the enactment of this Title, the Commission shall promulgate regulations and standards for implementing this section. No sale by a power producer shall be approved by the Commission until such standards have become effective.

SECTION 6: REQUIREMENTS APPLICABLE TO UTILITIES AND UTILITY

AFFILIATES--(a) Advance Review of Retail Utility Acquisitions: No retail utility or affiliates thereof may acquire, directly or indirectly, by any means, more than 5 per centum of a power producer, whether or not exempt, unless --

(1) the Commission finds that such acquisition will advance the public interest and the interests of consumers,

and will not affect adversely the cost of capital of such retail utility; and

(2) no affected State commission has disapproved such acquisition.

(b) Limitation on Retail Utility Ownership:

(1) No applicant shall be eligible for any exemption under section 4 of this Title if one or more retail utilities or affiliates thereof own more than 50 per centum of or exercise controlling influence over, or, as a result of a proposed acquisition, will own more than 50 per centum of or exercise controlling influence over, any exempt power producer.

(2) If a power producer exempt under section 4 takes any action the result of which would result in a violation of subsection 6(b)(1), the Commission shall revoke any exemption of such retail utility or affiliate power producer granted pursuant to this Title.

(c) Financing by Registered Holding Companies: The issuance of securities by a registered holding company for purposes of financing the acquisition of a power producer, the guarantee of securities of a power producer by a registered holding company, the entering into service, sales or construction contracts, and the creation or maintenance of any other relationship between a power producer and a registered holding company, its affiliates, and associate companies other than



acquiring or holding the securities or any other ownership interest in one or more non-utility power producers shall remain subject to review under the Holding Company Act.

(d) Transactions between Utilities and Affiliate Power Producers: Notwithstanding any other provision of this Title, an affiliated exempt power producer shall not engage, directly or indirectly, in any transaction with any affiliated public utility, except that the retail utility may pay dividends to, or receive dividends from, such exempt affiliate power producer in accordance with such rules and regulations as the Commission may deem necessary to protect the financial integrity of the retail utility and the interests of its consumers.

(e) Prohibition of Reciprocal Preferences.--(1) It shall be unlawful for any public utility company or public utility holding company that is an affiliate or associate company of a power producer, directly or indirectly, to--

(A) make or grant any preference or advantage to such power producer with respect to transmission service, power purchases, power sales, coordination services or interconnections;

(B) deny or withhold from any person or municipality that sells electricity for resale any service or the use of any property of such public utility company, or public utility holding company that

is not denied or withheld from an affiliate power producer; or

(C) enter into any contract or agreement with any other public utility company or public utility holding company, or affiliate or associate company thereof, for any purpose prohibited in subsections (e)(1)(A) or (B) of this section.

(2) Penalties.-- Any public utility company or public utility holding company that causes or permits to be done any act, matter, or thing prohibited or declared to be unlawful by this section, or omits to do any act, matter, or thing required by this section,

(A) shall be liable to the person or persons injured thereby for the trabled amount of damages sustained in consequence of such violation, together with reasonable attorney's fees, to be fixed by the court or Commission, which attorney's fees shall be taxed and collected as part of the costs in the case.

(B) shall be prohibited from acquiring any interest in, or from operating, any eligible facility, not in existence as of the determination of a violation of this Act, for a period to be set by the court or commission, but in no event less than 5 years.

(f) Implementing Regulations: Not later than 180 days after enactment of this Title, the Commission shall promulgate

standards that the Commission shall use in determining whether the requirements of this section are satisfied. No sale by a power producer shall be approved by the Commission until such standards have become effective.

#### SECTION 7: OTHER REQUIREMENTS RELATED TO EXEMPT POWER PRODUCERS

(a) Disposition, Merger or Consolidation: No exempt power producer or affiliates thereof shall dispose of, merge or consolidate any eligible facility of an exempt power producer unless

(1) the applicant certifies to the Commission that (A) it has notified each affected State Commission of such action and (B) the action is not inconsistent with any State law; and

(2) the Commission finds, after opportunity for hearing, that such action will not tend toward a situation inconsistent with the requirements for exemption under this title or any other provision of law.

(b) Ownership of Eligible Facilities and Qualifying Facilities: The ownership by a power producer of one or more eligible facilities, located in the United States or abroad, for which an exemption has been obtained under section 4 of this Act, shall not result in such power producer being considered as being primarily engaged in the generation or sale of electric power

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within the meaning of sections 3(17)(C)(ii) and 3(18)(B)(ii) of the Federal Power Act.

(c) Access to Books and Records:

(1) Upon written order of the Commission or a State commission, books and records shall be open to public inspection, and shall be subject to subpoena and other process of law, to no lesser extent as comparable information required of retail utilities under State law or Commission regulations; provided, that trade secrets and other sensitive commercial information shall be exempt from public disclosure or disclosure to potential competitors of such affiliate power producer by an affected State commission and shall not be provided to a State commission unless such commission has in place procedures for protecting the confidentiality of such information.

(2) Any United States district court located in the State in which the State commission referred to in paragraph (1) is located shall have jurisdiction to issue an injunction compelling compliance with an order issued by the State commission under this subsection.

(3) For purposes of this subsection, "books and records" means the books, accounts, memoranda, contracts, and records of --

(A) an electric utility company subject to regulatory authority under State law,

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(B) any power producer selling power at wholesale to such electric utility, and

(C) any subsidiary company, associate company, or affiliate of the electric utility company or the power producer, wherever located, if access to such books and records are required for the effective discharge of the Commission's or State commission's regulatory responsibilities affecting the provision of electric service.

SECTION 8: ALTERNATIVE OWNERSHIP STRUCTURES

For the purposes of determining whether the Public Utility Holding Company Act applies to a person, a partnership or any similar ownership structure shall be deemed to be an affiliate of each limited or general partner of such partnership.

SECTION 9: TRANSMISSION

[Incorporate here basic principles of H.R. 2224]

SECTION 10: JURISDICTION OF OFFENSES: ENFORCEMENT OF

LIABILITIES AND DUTIES:--(a) Jurisdiction of violations of this Act or the rules, regulations, and orders thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by, or to enjoin any violation of, this Act or any rule, regulation, or order thereunder shall be as

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provided in section 317 of the Federal Power Act (16 U.S.C. 825p.)

(b) Any person, state, municipality or State commission aggrieved by any act, matter, or thing done or omitted to be done by any person subject to the provisions of this Act may file a complaint with the Commission. The Commission shall dispose of such complaint according to the procedures of Section 306 of the Federal Power Act. (16 U.S.C. 825e). The relief requested by such complainant, and granted by the Commission, may include revocation or conditioning of any exemption, but only upon a finding, after notice and opportunity for hearing, that the requirements for exemption under this Title are no longer satisfied.

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**APPENDIX H**  
**SYNOPSIS OF REGIONAL REGULATORY LEGISLATION**

**RESTORING STATE REGULATION:  
A LEGISLATIVE PROPOSAL FOR RESOURCE PLANNING  
BY REGISTERED HOLDING COMPANIES**

**A. THE PROBLEM: MP&L CREATED A GAP IN STATE REGULATION**

1. In Mississippi Power & Light v. State of Mississippi ex rel. Moore, 487 U.S. 354 (1988), the U.S. Supreme Court authorized certain regional electric utility holding companies to avoid State regulation. By shifting their generation activities from retail to wholesale subsidiaries, these companies can shift regulatory review from State commissions to FERC.<sup>1</sup>
2. MP&L created a major gap in utility regulation. Here is how the law shapes up today:
  - a. Regional holding companies are a reality.
  - b. Therefore resource planning on a regional basis is a reality.
  - c. No one today has clear authority to regulate resource planning by a regional holding company.
    - (1) After MP&L, State commissions regulating the subsidiaries of a registered holding company lack clear authority over retail rates. Without clear authority over retail rates, they lack clear authority to regulate resource planning.
    - (2) FERC does not have clear authority either, because Section 201 of the Federal Power Act states that FERC lacks authority over generating facilities. Even if FERC does have authority, it lacks the State-by-State knowledge necessary to regulate planning consistent with local needs. Yet

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<sup>1</sup> The MP&L decision was an interpretation of the Federal Power Act. FERC had allocated capacity from a wholesale generating subsidiary of Middle South (now Entergy) to Middle South's four retail utility subsidiaries. The Court found that because Entergy was a centrally planned holding company, FERC's allocation preempted each State commission from questioning the prudence of any of the retail subsidiaries in acquiring that capacity. The State commission therefore had to pass through to retail customers the FERC-approved wholesale costs.



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MP&L still provides for FERC preemption.

- d. States therefore have the worst of both worlds: preemption without planning. A multi-State holding company can build a plant in one State and have FERC allocate the costs to other States, even if those other States prefer conservation or power purchases over construction.
3. Because this gap stems from the Federal Power Act, federal legislation is necessary.
4. The MP&L preemption problem exists independently of Congressional proposals to amend the Public Utility Holding Company Act. Those proposals would exacerbate the problem by increasing the number of wholesale transactions with potential preemptive effect.

**B. BASIC OUTLINE OF PROPOSAL FOR REGIONAL PLANNING ON REGISTERED HOLDING COMPANY SYSTEMS**

1. State Option to Require Regional Integrated Planning: States served by a registered holding company would have the option of requiring that the holding company file a "regional integrated resource plan." Thus States could volunteer to do together what no one does now: plan on a regional basis.
2. Paths to the Plan
  - a. A plan could come about through any one of the following paths listed below.
  - b. A regional regulatory board, formed by all of the States who regulate a particular holding company, could approve a specific plan by unanimous vote. The board may certify to FERC

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<sup>2</sup> The proposals permit utilities to create wholesale affiliates without review under PURCA. This new world will produce an increase in FERC-regulated wholesale transactions. Many of those transactions will trigger MP&L preemption. Until Congress clearly restores state regulation, every new wholesale affiliate creates the risk of further erosion of traditional state jurisdiction.

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any specific issue for decision.

- c. Either the holding company could submit a plan to FERC, or one or more State commissions could require the holding company to do so. FERC would hold a proceeding in which any interested party could participate and one or more State commissions could present alternative plans. FERC would be required to approve that plan most likely to minimize projected system cost, balancing the interests of shareholders and customers.
- d. Each State served by the holding company promulgates its own in-State plan. Then either of two options is available:
  - (1) The holding company can fashion a single regional plan consistent with each in-State plan. If no State objects, the plan would be approved by FERC.

OR

- (2) Each State can certify that each other State's plan is consistent with its own plan. Then the set of State plans is deemed to be a regional plan and is approved by FERC, unless the holding company argues, and FERC finds, that the individual plans are inconsistent or, when considered in combination, do not satisfy the statutory requirements for a plan. (See below for the statutory requirements.)

### 3. Preference for State- or Board-Initiated Plans

- a. The proposal expresses a preference for plans initiated through Paths (b) and (d) above. A FERC process (e.g., one initiated by a holding company) could not begin unless states were notified first and chose not to initiate their own process through a Board (Path (b)) or with their own state plans (Path (d)). Moreover, in any FERC proceeding (Path (c)), FERC would have to choose among the plans before it, rather than amend the plan. If FERC found that no plan before it satisfied the statutory requirements, FERC would have to

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provide an explanation and give the parties a chance to resubmit. Finally, the standard for FERC review of plans submitted through Patha (b) and (d) would be deferential to States.

- b. **NOTE:** A State is always free to enact its own in-State integrated resource plan, which would apply to the operating subsidiaries serving that State. This concept allows States to take a leading role in influencing the regional plan.
4. **Statutory Requirements of Plans:** The regional integrated resource plan would be a "least cost" electric power and energy conservation plan.
  - a. It would evaluate a range of resources and actions, including but not limited to, use, allocation, ownership, or disposition of existing facilities, construction of new facilities, acquisition of new power supplies, energy conservation, and renewable energy resources.
  - b. The plan would select from this range a set of resources and actions which will meet expected future demand for electricity at the lowest system cost for the registered holding company as a whole, balancing the interests of shareholders and customers.
  - c. The plan would assign risks and costs in advance, so that investors, consumers and regulators could act responsibly.
  - d. The plan would include a procedure for updating the plan at least once every two years.
5. **Filing at FERC Under NP&L:** The plan would be filed as a contract at FERC. The contract would bind FERC, the holding company and the States. Unless the States agreed otherwise, FERC could modify the contract only under limited circumstances.
6. **Regional Boards are Optional:** Formation of a regional board to review and oversee implementation of the plan would be optional. The goal is to produce a regional plan, not to create a regional board.

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7. Effect on FERC's Authority: FERC still would set wholesale rates, consistent with the regional plan. The legislation would not overturn NP&L.

**SUMMARY OF CHARLES A. PATRIZIA'S TESTIMONY  
ON BEHALF OF AN AD HOC GROUP OF  
REGISTERED ELECTRIC UTILITY HOLDING COMPANIES  
BEFORE THE  
SENATE SECURITIES SUBCOMMITTEE  
SEPTEMBER 17, 1991**

I am testifying on behalf of an ad hoc group of eight registered electric utility holding companies. These utility holding companies, through their operating and service company affiliates, serve over 12.5 million consumers in twenty states, account for approximately 13.5 percent of the total electricity generation capacity of the United States and have over 90,000 employees.

New capacity will be needed in the coming years, and it is up to Congress to choose whether to amend the law so that some portion of that capacity will come from exempt wholesale generators ("EWGs"). The registered electric holding companies, like the industry generally, hold different views on the need for new corporate structures to encourage construction of generating facilities. The registered companies I am testifying on behalf of are united, however, behind three principles essential to any amendments that would alter the requirements of the '35 Act. These principles are:

1. If FUECA is to be amended, all types of entities, regardless of ownership or affiliation, must be able to participate on the same basis.
2. Transmission access is a complex issue and legislation must not undercut the fundamental obligation of ensuring system reliability and protecting native load customers.
3. Regulatory burdens and uncertainty should not be increased and certainly should not be increased only for some.

We believe Title XV of S. 1220 meets these key principles, and we would be very concerned about further amendments to S. 1220 that would alter the careful balance it achieves.

We endorse the approach adopted in S. 1220 to the extent it allows registered companies to own EWGs on an equal basis. In particular, we support Title XV's treatment of the Security and Exchange Commission's regulatory review process for EWGs and the issue of EWG financing.

Contrary to the claims of some proponents of increased transmission access, transmission access is an extremely complex issue. Mandated interconnections without utility input and proper consideration of local distribution or customer needs would decrease our flexibility and operational authority, directly affect our ability to maintain an economic and reliable electric power system, and likely have adverse impacts on native load customers. With respect to the issue of transmission access, the registered companies have different views. At least one of the registered companies supports the enactment of transmission legislation which would provide FERC with greater authority to order wheeling. All of the registered companies believe, however, that any transmission access policy must protect economic and reliability interests of native load customers. We believe that the issue need not be addressed as part of changes to the '35 Act, and to that extent believe S. 1220 adopts the appropriate position.

Finally, Congress should not accept proposals for deregulation simply for the sake of deregulation or alterations of regulatory authority and procedure that would further burden the industry by increasing the likelihood of multiple, disparate regulatory decisionmakers and decisions. Amending PUHCA to change the carefully crafted regulatory framework which has served well for the last 55 years and substitute multiple decisionmakers in multiple forums would not be acceptable reform. It would hamstring those subject to regulation -- the companies now providing reliable and economic service; and effectively bar them from a fair opportunity to continue competing, by creating a new favored class exempt from regulation.



**TESTIMONY OF**

**JAMES R. DOTY, GENERAL COUNSEL  
U.S. SECURITIES AND EXCHANGE COMMISSION**

**CONCERNING TITLE XV OF S. 1220**

**BEFORE THE SUBCOMMITTEE ON SECURITIES  
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS  
UNITED STATES SENATE**

**SEPTEMBER 17, 1991**

**U. S. Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549**

**TESTIMONY OF JAMES R. DOTY, GENERAL COUNSEL  
SECURITIES AND EXCHANGE COMMISSION  
CONCERNING TITLE XV OF S. 1220  
SEPTEMBER 17, 1991**

**-SUMMARY-**

S. 1220, the "National Energy Security Act of 1991," is intended, among other things, to remove the impediments the Public Utility Holding Company Act of 1935 (the "Act") presents to the development of a competitive wholesale power market. The Commission has attempted, within the limits of the Act, to accommodate the development of independent power production. The Commission's powers, however, are severely limited by the express language of the Act.

Under current law, wholesale power generators are electric utility assets for purposes of the Act because they generate electrical energy. Thus, if a company such as General Electric, which manufactures generating equipment, wanted to own a wholesale power generator, it would be subject to all of the strictures of the Act, including, most significantly, divestiture of all businesses not functionally related to the operations of the generating company, and restriction of its operations to a single area or region. Obviously, these statutory consequences constitute a powerful deterrent to potential new entrants to the wholesale generation business and present an effective barrier to competition in power generation.

It is important to note what the bill does not do: it does not eliminate Commission jurisdiction over existing registered public-utility holding company systems. With respect to companies in such systems, the Commission retains full authority over issuances of securities, acquisitions of securities and interests in other businesses, affiliate transactions and public reporting. With respect to exempt holding companies, the acquisition of an exempt wholesale generator would not remove the holding company system from state jurisdiction. The bill does not require any utility to purchase power from a wholesale generator; the bill is permissive. Finally, the bill does not alter the Federal Energy Regulatory Commission's jurisdiction over operating utility companies in both registered and exempt holding company systems.

The Commission believes that adequate safeguards for the protection of the interests of investors are provided in the proposed legislation, in disclosure requirements under the federal securities laws, and in the market. The Commission also believes that the interests of consumers generally can be protected by other regulatory entities: the Federal Energy Regulatory Commission, determining market-based wholesale rates for wholesale generators at the federal level, and the various state utility regulatory commissions to which wholesale generators would be subject.



TESTIMONY OF  
JAMES R. DOTY, GENERAL COUNSEL  
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING TITLE XV OF S. 1220

BEFORE THE SENATE SUBCOMMITTEE ON SECURITIES  
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

SEPTEMBER 17, 1991

Chairman Dodd and Members of the Subcommittee:

I appreciate this opportunity to testify before you on behalf of the Commission regarding Title XV of S. 1220, the "National Energy Security Act of 1991."

Among its other responsibilities, the Commission administers the Public Utility Holding Company Act of 1935 (the "Act"). The proposed legislation is intended to remove the statutory barriers that the Act presents to the development of a competitive wholesale power market. Presently, the Act is a formidable obstacle to the development of that market.

A. The Public Utility Holding Company Act of 1935

During the first part of this century, far-flung, highly-leveraged holding company systems dominated the public-utility industry. The complex capital structures of these systems made it difficult, if not impossible, for investors to analyze the quality of earnings and the financial condition of the companies in which they were investing. In the 1930s, many of the holding

companies collapsed, leaving investors with billions of dollars of losses.

At that time, utility regulation, as we know it, was in its infancy. State utility commissions were either nonexistent or extremely limited in power and there was no meaningful regulation of the utility industry at the Federal level. Securities regulation was similarly a new undertaking. When the Act was passed in 1935, the SEC was just one year old, and the cornerstone federal securities laws, the Securities Act of 1933 and the Securities Exchange Act of 1934, were brand new.

Following extensive studies and hearings, the Congress enacted The Public Utility Act of 1935, which was comprised of two separate but complementary pieces of legislation, the Public Utility Holding Company Act of 1935 and the Federal Power Act ("FPA"). 1/ Congress assigned to the SEC, the agency created to oversee public company finance, the responsibility for administering the Act to regulate the corporate structure and financing of public-utility holding company systems. The Federal Power Commission, now the Federal Energy Regulatory Commission

1/ The Public Utility Act of 1935, ch. 687, 49 Stat. 803, included Title I, which is the Public Utility Holding Company Act of 1935, 15 U.S.C. 79 at seq., and Title II, which is designated Parts I and II of the Federal Power Act, 16 U.S.C. 824 at seq.

("FERC"), was established to oversee the interstate wholesale power markets. 2/

The specific goal of the Act was to protect investors and consumers from the myriad abuses made possible by complex holding company structures. 3/ The statute, therefore, mandates a simple and clear ownership structure for public utilities. A free-

- 2/ Justice Stevens, concurring in a recent Supreme Court decision, explained:

Congress enacted [the Act] to prevent financial abuses among public utility holding companies and their affiliates. It entrusted the [Commission], the agency with the expertise in financial transactions and corporate finance, with the task of administering the act. The [Commission] carries out its duties essentially by monitoring inter-affiliate financial transactions and eliminating potential conflicts of interest. Congress enacted the FPA to regulate the wholesale interstate sale and distribution of electricity. It entrusted the administration of the FPA . . . to the FERC as the agency with the technical expertise required to regulate energy transmission.

Arcadia v. Ohio Power Co., \_\_\_\_\_ U.S. \_\_\_\_, 111 S. Ct. 415, 423 (1990) (citations omitted).

- 3/ The specific abuses identified by Congress included the pyramiding of voting control, excessive leverage, securities issued upon the basis of fictitious and unsound asset values, intrasystem profiteering on transfers of assets, financial mismanagement, excessive intrasystem management fees and service charges, the concentration of economic power not susceptible to state regulation, and the expansion of holding company systems without regard to the integration and coordination of related utility properties. See section 1(b).

standing public utility is not subject to the Act. If, however, a utility is part of a holding company system, the strictures of the Act come into play.

The Act's key terms are broadly defined. A "holding company" is "any company which directly or indirectly owns, controls, or holds with power to vote, 10 per centum or more of the outstanding voting securities of a public-utility company." 4/ An "electric utility company" is "any company that owns or operates facilities used for the generation, transmission, or distribution of electric energy for sale." 5/

The Act requires all companies that meet the statutory definition of a "holding company" either to register with the Commission or to obtain an exemption. Generally, holding companies with significant multi-state utility operations must register and, in so doing, subject themselves to the stringent limitations the Act imposes upon the businesses of registered holding companies.

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4/ Section 2(a)(7)(A). This section is the "bright line" standard for determining holding company status. The Commission also may impose holding company regulation on "any person" under section 2(a)(7)(B) if, after notice and hearing, it determines that such person exercises sufficient controlling influence over a utility to make it necessary or appropriate in the public interest or for the protection of investors or consumers to treat that person as a holding company.

5/ Section 2(a)(3). See also section 2(a)(4) (definition of "gas utility company").

Section 11 sets forth the basic integration and simplification requirements of the Act for registered holding companies. 6/ A key provision standing as an obstacle to the development of a competitive wholesale power market is section 11(b)(1), which limits each registered system to a "single integrated public-utility system." The Act defines "integrated public-utility system" in terms of a group of naturally related properties within a single area or region. 7/ Section 11(b)(1) limits the ability of registered holding companies to engage in business activities other than their utility operations. 8/

The Act subjects registered holding companies to restrictive financial and operational requirements. Among those particularly relevant to the development of independent power generators are the following:

- Sections 6 and 7: these sections require Commission approval before a registered company or its subsidiaries may

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6/ This section has been described as "the very heart of the title." SEC v. New England Elec. Sys., 384 U.S. 176, 180 (1966), citing North American Co. v. SEC, 327 U.S. 686, 704 n.14 (1946).

7/ Section 2(a)(29)(A).

8/ Under section 11, generally nonutility businesses may be acquired only if they are functionally related to the utility operations of the holding company system. Michigan Cons. Gas Co. v. SEC, 444 F.2d 913 (D.C. Cir. 1971).

issue most types of securities. The Commission may withhold approval if either the securities or their terms fail to meet specified qualitative standards. 2/ Section 7 gives the Commission wide latitude to refuse to authorize the issuance of any security not reasonably adapted to the security structure of the issuer and the other companies in the holding company system, or to the earning power of the issuer, or that is "not necessary or appropriate to the economical and efficient operation of a business in which the applicant lawfully is engaged or has an interest." 10/

- Sections 9 and 10: these sections require Commission approval of the acquisition of securities or utility assets by a registered holding company or its subsidiaries. A key provision is section 10(c)(1), which prohibits the Commission from approving any acquisition that would be detrimental to the carrying out of the integration and simplification provisions of section 11.

- Section 12: this section prohibits loans from an operating utility to a parent registered holding company and requires Commission approval for various other types of

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2/ Eastern Utils. Assocs., Holding Co. Act Release No. 24641 (May 12, 1988). See generally sections 7(c), 7(d), and 7(e).

10/ Section 7(d)(3).

intercompany financial transactions, such as loans from the parent holding company to the utility.

- Section 13: this section authorizes the Commission to regulate service, sales, and construction contracts between operating utilities and other companies within the same registered holding company system and requires that such services be performed at cost.

- Section 13: this section authorizes the Commission to require the filing of annual, quarterly, and other periodic reports by registered holding companies, and to require such reports to be certified by an independent public accountant.

- Section 15: this section authorizes the Commission to establish the form of accounts and prescribe uniform methods of accounting for registered holding companies.

Because Congress did not believe that all public-utility holding companies should be subjected to pervasive federal control, section 3 authorizes the Commission to exempt some holding companies from registration and other provisions under the Act. The Commission is "directed" to exempt a holding company if it falls into one of five enumerated categories of

section 3(a). 11/ Under the so-called "unless and except" clause of section 3, however, the Commission may deny an exemption to a company that meets the objective criteria of section 3(a), upon determining that the exemption would be detrimental to the public interest or the interest of investors or consumers. 12/ The Commission may also terminate an exemption if it finds that the circumstances that gave rise to the exemption no longer exist. 13/

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11/ The five categories for exemption under section 3(a) are:

- (1) the holding company and its material public-utility subsidiaries are all organized and carry on their business substantially in one state;
- (2) the holding company is itself an operating utility whose operations do not extend beyond the state in which the holding company is organized and contiguous states;
- (3) the holding company is only incidentally a holding company and the utility operations are functionally related to the holding company's primary nonutility business;
- (4) the holding company is only temporarily a holding company (e.g., a bank that acquires title to pledged securities); or
- (5) the holding company does not derive a material part of its income from domestic utility operations.

12/ Section 3(a) provides that the Commission shall exempt a holding company that meets the criteria of that section "unless and except insofar as it finds the exemption detrimental to the public interest or the interest of investors or consumers."

13/ Section 3(c).



Exempt holding companies generally are not subject to the requirements the Act imposes on registered holding companies. Section 9(a)(2) is a significant exception to this rule. That section prohibits "any person" who owns five percent or more of the voting securities of a public utility -- and so, is a statutory "affiliate" of that company -- from acquiring five percent or more of the voting securities of another public-utility company, without prior Commission approval.

B. The Application of the Act to Wholesale Power Generators

Wholesale power generators, wherever located, are electric utility assets for purposes of the Act because they generate electrical energy. 14/ Any company that owns or operates a generator is presumptively an electric utility company under section 2(a)(3), and any company that owns or controls a generating company would be a public-utility holding company under section 2(a)(7). Thus, if General Electric (which manufactures generators) or Burns & Roe (which engineers power plants) were the owner of a wholesale power generator, each company would be subject to all of the strictures of the Act, including, most significantly, divestiture of all businesses not functionally related to the operations of the generating company, and restriction of its operations to a single area or region. As might be expected, these statutory consequences offer a powerful

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14/ Section 2(a)(18).

deterrent to potential entrants in the wholesale generation business and represent an effective barrier to competition in power generation.

There are a few narrow exceptions to this result. A company that invested in a single wholesale power generator might qualify as an exempt holding company under one of the five narrowly drawn provisions in section 3(a). The two most widely-used exemptions are those provided in sections 3(a)(1) and 3(a)(2), generally known as the "intrastate exemption" and the "predominantly a public utility exemption," respectively.

The "intrastate exemption" requires, among other things, that each material public-utility subsidiary company be organized and carry out its business substantially in the same state in which the holding company is organized. Thus, while the owner of a wholesale power generator could use this exemption for projects in a single state, the exemption would not be available if the owner wanted to build in several states. And even for a purely intrastate wholesale power generator owner, the Act would pose some regulatory problems. Section 9(a) would require Commission approval of the acquisition of utility securities by "any person" if the acquisition would result in that person becoming an "affiliate" of more than one public utility. <sup>15/</sup> And, as noted

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<sup>15/</sup> An affiliate is defined as a "person" that owns, controls, or holds with power to vote, five percent or more of the  
(continued...)

below, the Commission may not approve an acquisition under section 9 unless it makes the requisite findings under section 10.

The "predominantly a public utility" exemption likewise is not broadly useful. This exemption extends to a holding company that is also a public-utility company whose operations do not extend beyond the state in which the holding company is organized and contiguous states. Again, the exemption would limit the geographic area of operation of any person wishing to own a generating company. Further, the exemption would hamper those who typically want to finance and control each power project through a separate subsidiary rather than have appreciable utility operations at the holding company level. Use of such separate subsidiaries is typically preferred for tax, liability, and other reasons. 16/

As noted above, a company seeking to acquire an interest in more than one wholesale power generation company must clear the

15/ (...continued)  
outstanding voting securities of a company. Section 2(a)(11)(A).

16/ The other three classes of exemption are similarly unhelpful. The Commission has interpreted section 3(a)(3) to require that the utility operations be functionally related to the primary nonutility business of the holding company. Cities Serv. Co., 8 S.E.C. 318 (1940); see Standard Oil Co., 10 S.E.C. 1122, 1125 n.5 (1942); Manufacturers Trust Co., 9 S.E.C. 283, 288 n.5 (1941). Section 3(a)(4), by its terms, does not apply, and section 3(a)(5) envisages a company that does not derive a material part of its income from domestic utility operations.

hurdles of sections 9 and 10. Section 9(a) requires Commission approval of an acquisition of such interest and links that approval to the provisions of section 10. The standards set forth in section 10 include requirements that the acquisition not unduly concentrate control of utility systems, that the purchase price be reasonable, that the purchase not unduly complicate the capital structure of the resulting system, and, most troublesome for independent power producers, that the transaction serve the public interest by tending toward the economic and efficient development of an "integrated public utility system." 17/

This "integration" requirement effectively forecloses persons from undertaking projects in geographically separate locations within the United States. A person with a wholesale generation company or other utility operations in Connecticut could not, for example, acquire another one in Texas.

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17/ Section 2(a)(29)(A) generally defines an integrated public-utility system as "a system . . . whose utility assets, whether owned by one or more . . . utility companies, are physically interconnected or capable of physical interconnection and which under normal conditions may be economically operated as a single interconnected and coordinated system confined in its operations to a single area or region . . . not so large as to impair . . . the advantages of localized management, efficient operation, and the effectiveness of regulation." For a discussion of the integration requirement, see generally, R.F. Ritchie, Integration of Public Utility Holding Companies (1954).

The Act, however, may excuse the acquisition of foreign utility operations from the integration requirement. 18/ A holding company exempt under section 3(a)(5) may freely acquire foreign utility companies. 19/ The Commission has not yet considered the circumstances, if any, under which other types of holding companies may own an interest in a foreign power plant. 20/

C. The Commission's Actions Regarding Independent Power Projects

The Commission has attempted, within the limits of the Act, to accommodate the development of independent power production. The Commission's powers, however, are constrained by the express language of the Act, and there is no question that developers of the relatively few projects constructed to date have been obliged

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18/ Section 10(c)(2), in pertinent part, provides: "This paragraph shall not apply to the acquisition of securities or utility assets of a public-utility company operating exclusively outside the United States."

19/ See INDECK Energy Servs., Inc., Holding Co. Act Release No. 25237 (Jan. 4, 1991).

20/ There are presently pending before the Commission an application by a registered holding company concerning the acquisition of a Portuguese electric-utility subsidiary, Southern Co. (File No. 70-7689); and an application by an exempt intrastate holding company concerning the acquisition of electric-utility subsidiaries in the Pacific Basin, Hawaiian Elec. Indus., Inc. (File No. 31-843).

to create peculiar, inefficient, and somewhat artificial ownership structures because of the Act. 21/

For example, because the Act bases its presumption of control on the ownership of voting stock, a company could purchase nonvoting common or preferred stock of an independent power project and gain some of the economic benefits of ownership, without becoming a "holding company." 22/ Or, the parties to a project could establish a limited partnership with an exempt holding company as the general partner and the equity participants as limited partners. Relief from the Act in large part would turn on structuring the limited partners' interests as genuinely passive investments which afford the investors no meaningful ability to control or influence the partnership's

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21/ Congress with its enactment of the Public Utility Regulatory Policies Act of 1978 ("PURPA") provided a framework for initial development of an independent power industry, which included exemption from the Act for most so-called qualifying facilities ("QFs"). 16 U.S.C. 2601 *et seq.* (1990). However, that exemption is limited to projects that meet the narrow requirements for QF status under PURPA, generally cogenerators and small power producers.

22/ See, e.g., *Ocean State Power*, SEC No-Action Letter (Feb. 16, 1988) (where the voting interests of certain general partners were decreased below five percent and ten percent, respectively, these partners could retain large equity interests without becoming subject to regulation as an affiliate or holding company, respectively, under the Act).

affairs. 23/ For obvious reasons, this approach is not attractive to many investors.

Finally, under section 3(d), the Commission could exempt a specified class of persons from the definition of "subsidiary company" or "affiliate" within the meaning of the Act. 24/

23/ The Commission has not yet considered the status under the Act of the developer of a domestic independent power project. The industry has developed largely in the interstices of the Act, in reliance on two no-action letters issued by the staff of the Division of Investment Management. Colstrip Energy Ltd. Partnership, SEC No-Action Letter (June 30, 1988) (staff indicated that it would not recommend enforcement action where developer became general partner and circumstances indicated that the limited partners would not exercise such a controlling influence as to warrant regulation as a holding company); Catalyst Energy Co., SEC No-Action Letter (Jan. 21, 1988) (staff indicated that it would not recommend enforcement action where developer became limited partner and circumstances indicated that the limited partner would not exercise such a controlling influence as to warrant regulation as a holding company); see also Nevada Sun-Peak Ltd. Partnership, SEC No-Action Letter (May 14, 1991) (staff indicated that it would not recommend enforcement action where circumstances indicated that the limited partner would not exercise such a controlling influence as to warrant regulation as a holding company). The relief available through the "no-action" process is circumscribed by the facts and circumstances of the particular matter. The developer of an independent power project has filed an application under section 2(a)(7) for formal Commission determination of its status. Doswell II Ltd. Partnership (File No. 31-858).

24/ Section 3(d) provides:

The Commission may, by rules and regulations, conditionally or unconditionally exempt any specified class or classes of persons from the obligations, duties, or liabilities imposed upon such persons as subsidiary companies or affiliates under any provision or provisions of this title, and may provide within the extent of any such

(continued...)

However, this section, by its terms, could not effect the broad exemption from the Act that the proposed legislation would provide for investors and developers.

None of the above administrative "solutions" provides a satisfactory resolution to the strictures found in the Act. Although the Commission is not aware of any independent power projects that have not come to fruition because of the impediments posed by the Act, we certainly recognize that structuring projects to avoid the Act means substantial additional time, trouble, and expense for wholesale power project developers. 25/

#### D. Responses to Specific Questions

You have asked the Commission to address certain questions regarding the impact of the proposed legislation on various matters relating to the Act. As discussed above, the purpose of the Act is to protect the interests of investors and consumers of

24/ (...continued)

exemption that such specified class or classes of persons shall not be deemed subsidiary companies or affiliates within the meaning of any such provision or provisions, if and to the extent that it deems the exemption necessary or appropriate in the public interest or for the protection of investors or consumers and not contrary to the purposes of this title.

25/ Independent Developers Finding Solutions to PUHCA Elusive, Electric Util. Week, Apr. 8, 1991, at 9, col. 1, quoting Peter Lalor of Long Lake Energy Corporation.



public-utility holding company systems. Therefore, those questions ( No. 2 and No. 6) that concern the effect of Title XV on the nation's energy supply and the environment are beyond the purpose of the Act and the Commission's expertise. Accordingly they are not addressed in this testimony.

The remaining four questions concerning Title XV of S. 1220 are as follows:

Question 1. What are the implications of Title XV of S. 1220 as it relates to consumer utility rates?

The Act does not and was never intended to regulate utility rates. Rate regulation is the province of the FERC and the state regulatory commissions. In the past, the Act may have had some indirect effect on consumer rates because it regulates the corporate and financial structure of registered holding companies, and transactions between such holding companies and their affiliates. 26/ Before state utility commissions gained

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26/ As the Commission explained in American Elec. Power Co., 46 S.E.C. 1219, 1223 (1978):

[Our] control over [registered holding] companies relates only to their structure, to their intrasystem transactions, and to their finances. We have no power over their dealing with their customers, retail or wholesale.

See also City of Lafayette v. SEC, 464 F.2d 941 (D.C. Cir. 1971), aff'd sub nom. Gulf States Utils. v. FPC, 411 U.S. 797 (1973). The Act does not regulate the operations of utility companies as such, and the Commission has no jurisdiction over sales of energy. The FERC focuses upon the technological and policy issues associated with energy  
(continued...)

the ability to monitor these kinds of issues and to take them into account in setting rates, the Act may have played some role.

S. 1220 would eliminate the Commission's review of the acquisitions by registered holding companies of wholesale generators and would allow certain acquisitions that would otherwise have been prohibited by the Act. The legislation would retain the Act's prohibitions on cross-subsidization and the general requirement that transactions between affiliates be "at cost." While existing state and FERC regulation has largely made these extra safeguards redundant, their presence in the proposed legislation will help assure that utility customers are not asked to subsidize businesses with no functional relation to the providing of electrical power.

In addition, the Act geographically restricts the corporate structure of public utilities. 27/ S. 1220, which would exempt wholesale generators from the Act's restrictions regarding geographic expansion, would create the possibility of new interstate holding companies that would not be required to register under the Act. That is consistent with the Act's

26/ (...continued)  
generation and transmission. See generally Welch, Functions of the Federal Power Commission in Relation to the Securities and Exchange Commission, 14 Geo. Wash. L. Rev. 81 (1945).

27/ Congress intended that the Commission's work be coordinated with and complement the work of state commissions. See, e.g., sections 6(b), 7(g), 8, 10(f), 18, 19 and 20(b).

purposes, as there has been a significant increase since 1935 in the effective reach of state utility regulation. Indeed, the proposed legislation provides for increased state scrutiny of the costs to consumers of the purchase by retail utility companies of the power generated by the wholesale generators. 28/ It also requires FERC to review power sales between affiliated wholesale and retail companies. 29/

**Question 3.** What will be the impact of the proposed legislation upon the competitive environment for the generation of electricity, including the availability and reliability of transmission access?

Although S. 1220 will exempt wholesale generator acquisitions from Commission review (including review of anticompetitive effects), 30/ the bill will not shield the acquisition from anticompetitive analysis under other laws. 31/ In particular, the FERC, in its determination whether to grant

28/ See *infra*, pp. 19-20.

29/ See *infra*, p. 21.

30/ Under section 10(b)(1), the Commission cannot approve an acquisition that would "tend towards . . . the concentration of control of public-utility companies, of a kind, or to an extent, detrimental to the public interest or the interest of investors or consumers." The Commission's analysis under section 10(b)(1) includes consideration of the anticompetitive effects of an acquisition. Northeast Utils., Holding Co. Act Rel. No. 25273 (Mar. 15, 1991) and No. 25221 (Dec. 21, 1990).

31/ For example, the federal antitrust laws, including the Hart-Scott-Rodino Antitrust Improvements Act of 1976, will continue to apply.

market-based rates, considers the potential for anticompetitive behavior. The Commission believes that the expertise and technical ability for resolving anticompetitive issues involving transmission access and bulk power supply lie principally with the FERC.

The states, in administering their competitive bidding programs, can also guard against abuses. The Commission notes that section 15107 of S. 1220 amends PURPA to require those state regulatory agencies that allow electric utilities to purchase long-term wholesale power supplies as a means of meeting incremental electric demand to perform a general evaluation regarding: (1) the cost of capital for such utilities, and any resulting changes in the retail rates paid by consumers that may result from purchases of long-term wholesale power in lieu of the construction of new generation facilities; (2) the effect upon the reliability of electric service that may result from purchases of long-term wholesale power from sellers with higher levels of debt in their capital structures; and (3) whether the use by exempt wholesale generators of capital structures employing less than 35% equity threatens reliability or provides an unfair advantage for exempt wholesale generators. 32/

32/ In addition S. 1220 instructs state commissions to implement procedures for the advance approval or disapproval of the purchase of long-term wholesale power, which procedures reflect the results of the evaluation discussed above. The states must also require, as a condition for the approval of purchases of long-term wholesale power, that the  
(continued...)

Question 4.      How will current electric utility industry regulations that protect consumers and stockholders from utility abuse and conflicts of interest be affected by the proposed legislation?

The proposed legislation would leave in place substantial protections for consumers and stockholders in the electric utility industry sufficient in our view to avoid recurrence of the abuses that concerned the Congress in 1935. The Securities Act of 1933 and the Securities Exchange Act of 1934 govern financial reporting, and the disclosure requirements and accounting standards mandated by those laws have substantially diminished risk to investors. In addition, FERC has established uniform systems of accounts for both electric and gas utility companies, and most states have also adopted uniform systems of accounts for public-utility companies operating within their jurisdictions.

Today, state utility commissions are a powerful regulatory force in most states, and their national body, the National Association of Regulatory Utility Commissioners, is a strong leader in molding national policy. At the federal level, FERC plays an active role in detecting and curbing affiliate abuses.

32/ (. continued  
seller of such power has and will continue to have access to sources of fuel on terms adequate to provide a reasonable assurance of the seller's ability to perform its obligations under the power purchase contract.

In short, there now exist well-established systems to prevent the abuses that concerned Congress when the Act was promulgated.

If S. 1220 is enacted, the Commission will continue to monitor service, sales and construction contracts, and other relationships between a wholesale generator and an affiliate registered holding company under the Act. Moreover, section 15105 of S. 1220 provides that FERC may not approve a rate or charge for the sale of electric energy at wholesale by a wholesale generator as "just and reasonable" within the meaning of sections 205 and 206 of the FPA 33/ if the rate or charge allows the wholesale generator to receive an undue advantage resulting from the fact that the purchaser of such electric energy is an affiliate or associate company of such wholesale generator.

Question 5.      How will the proposed legislation impact the financial condition of public utility holding companies and the ability of investors to assess the financial condition of those companies?

While S. 1220 will allow a registered holding company to acquire one or more exempt wholesale generators without Commission approval, any issuance or sale of a security by a registered holding company for the purpose of financing an exempt wholesale generator, or any guarantee of a security of an exempt wholesale generator by a registered holding company, still must

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33/ 16 U.S.C. 824(d) and 824(e).

be approved by the Commission. In determining whether or not to grant such approval, the Commission must presently evaluate under section 7(d) whether, among other things, the proposed security is reasonably adapted to the security structure of the company issuing the security and to other companies in the registered system. 34/

Section 7 reflects Congress' desire that the traditional electric utility company have a simple capital structure and

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34/ Section 7(d) provides that, subject to other provisions in that section, the Commission must approve an issue or sale of a security unless it finds that:

- (1) the security is not reasonably adapted to the security structure of the declarant and other companies in the same holding company system
- (2) the security is not reasonably adapted to the earning power of the declarant;
- (3) financing by the issue and sale of the particular security is not necessary or appropriate to the economical and efficient operation of a business in which the applicant lawfully is engaged or has an interest;
- (4) the fees, commissions, or other remuneration, to whomsoever paid, directly or indirectly, in connection with the issue, sale, or distribution of the security are not reasonable;
- (5) in the case of a security that is a guaranty of, or assumption of liability on, a security of another company, the circumstances are such as to constitute the making of such guaranty or the assumption of such liability an improper risk for the declarant; or
- (6) the terms and conditions of the issue or sale of the security are detrimental to the public interest or the interest of investors or consumers.

incur only that amount of debt which can be adequately serviced by the operations of the utility. As a matter of regulatory policy, the Commission has generally required registered holding companies to maintain a 65% debt to 30% equity ratio on a consolidated basis (with the remaining 5% typically being preferred stock).

Exempt wholesale generators are likely to employ a higher degree of leverage, because they are typically project-financed through a substantial amount of nonrecourse debt. The nonrecourse feature limits exposure on the debt to the wholesale generator's assets only, so that the higher level of debt should not jeopardize the resources of the holding company. Nevertheless, registered holding companies investing in wholesale generators may also desire to participate in their financing by the purchase of equity or debt securities, or by the guarantee of debt securities, of wholesale generators.

To facilitate such financing, S. 1220 would modify the current standard of review under section 7(d) with respect to exempt wholesale generators. Section 15101(g)(3) provides that when evaluating a registered holding company's request to issue securities to finance the acquisition of an exempt wholesale generator, or to guarantee a security of an exempt wholesale generator, the Commission may find that the security does not meet the standards of section 7(d)(1) and (2) only if the



Commission first finds that the issue or sale of such security, or the making of the guarantee, would have "a substantial adverse impact on the financial integrity of the registered holding company system." 35/

Further, when determining whether or not to approve a transaction by a registered holding company or its subsidiaries other than with respect to exempt wholesale generators, section 15101(g)(4) of S. 1220 provides that the Commission may not consider the effect of the capitalization or earnings of any exempt wholesale generator subsidiary upon the registered holding company system unless the transaction, together with the effect of such capitalization and earnings, would have "a substantial adverse impact on the financial integrity of the registered holding company system." These provisions are intended to allow the Commission to implement a more flexible standard when evaluating the financial ability of a registered holding company to invest in exempt wholesale generators.

#### E. Conclusion

S. 1220, in the Commission's view, reflects a correct judgement that strict adherence to the integration requirements of the Act, as implemented in the 1930's, cannot work in the competitive economic markets that both the electric wholesale power industry and its regulators both foresee for the 1990's and

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35/ Section 15101(g)(3) of Title XV of S. 1220.

beyond. The approach of S. 1220 should facilitate the development of the wholesale generation industry, while retaining the Commission's ability to prevent financing transactions that implicate the Act's original concerns, such as the ability of investors to assess the financial condition of registered holding companies.

Thank you for allowing the Commission the opportunity to comment on the proposed legislation. I would be pleased to respond to any questions the Subcommittee may have.

September 17, 1991

**TESTIMONY OF CLIFTON A. LEONHARDT, CHAIRPERSON OF THE  
CONNECTICUT DEPARTMENT OF PUBLIC UTILITY CONTROL, BEFORE  
THE SECURITIES SUBCOMMITTEE, COMMITTEE ON BANKING,  
HOUSING AND URBAN AFFAIRS, U.S. SENATE ON TITLE XV OF S. 1220  
OF THE NATIONAL ENERGY SECURITY ACT OF 1991**

Good morning. I am Clifton Leonhardt, Chairperson of the Connecticut Department of Public Utility Control. Appearing with me today is the Executive Director of the Connecticut DPUC, Darcy McGraw. I appreciate the opportunity to testify before you on Title XV of Senator Johnston's Bill, S. 1220. Since the Connecticut DPUC has not taken a formal position on the issue of PUHCA reform, I am speaking today as an individual. I applaud the efforts of Congress to improve the efficiency of the electric utility industry, and commend this Committee for taking interest in this subject of national importance. I support both the purpose and the substance of S. 1220 Title XV, with certain modifications needed to assure that the benefits of PUHCA reform are indeed available to consumers. The modifications I suggest herein represent my best thinking at the present time, but as the PUHCA reform debate proceeds, I am sure that my own opinions will mature and change with reference to some important details.

**I. Overview of PUHCA**

"As 'a specialized antitrust act' the Holding Company Act differs from the general type of anti-monopoly statute in that it is designed to restore the effectiveness of State and Federal regulation, rather than the effectiveness of competition in the free market."<sup>1</sup>

As we consider reform of the Public Utility Holding Company Act (PUHCA or the '35 Act), in order to capture the benefits of competition, we must remember why PUHCA was enacted in 1935, and the safeguards it has provided for the last 56 years. Regulation under PUHCA was instrumental in

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<sup>1</sup> *The Public Utility Holding Company Act of 1935*, report of the Securities and Exchange Commission, Subcommittee on Monopoly of the Senate Select Committee on Small Business, Subcommittee Print No. 4, 82nd Cong., 2d Sess. (1952), at 1

breaking up the large pre-existing holding companies, preventing self dealing abuses, and precluding complex corporate structures that thwart effective state regulation.

The Act protects competition and consumers by:

1. Prohibiting corporate structures that are unduly complex and, thus, avoid state regulation;<sup>2</sup>
2. Requiring that utility acquisitions serve the public interest;<sup>3</sup>
3. Providing for auditing procedures and intra-system transaction limitations that prevent self dealing abuses and protect investor interests;<sup>4</sup>
4. Limiting utility diversification into unrelated business ventures which create risks for electric or gas consumers;<sup>5</sup>
5. Precluding utility acquisitions that monopolize new territories or power sources, or which create risks to consumers or investors.<sup>6</sup>

Under regulation by the Securities and Exchange Commission (SEC), most investor owned utilities have organized themselves under three basic models (See Exhibits CT 1-3). Single Integrated companies (SICs) avoid the holding company structure and PUHCA regulation entirely, even if operating across more than one state. Exempt Holding Companies (EHCs), whose subsidiaries are predominantly intrastate or otherwise qualify for PUHCA exemptions under Section 3(a), are subject to limited SEC scrutiny. Registered Holding companies (RHCs) operate utility subsidiaries in more than one state, and are thus directly under SEC regulation. The Connecticut DPUC currently regulates the major subsidiary of one RHC (Connecticut Light & Power, a subsidiary of Northeast Utilities), three EHCs (United Illuminating, Yankee Gas, and Connecticut Energy Corp.), and one SIC (Connecticut Natural Gas).

Current utility regulatory authority is allocated between state and federal agencies. States have authority over retail rates, siting of transmission and generation facilities, and the utility's obligation to serve its captive

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<sup>2</sup> Section 11

<sup>3</sup> Such acquisitions must tend towards economical and efficient development of an integrated public utility system. Section 10(c)(2)

<sup>4</sup> Section 13 requires that inter-affiliate transactions be at cost and prevents cross subsidization. Sections 14 and 15 specify reporting requirements and SEC access to books and records.

<sup>5</sup> Section 1(b), Section 11(b)(1)

<sup>6</sup> Section 10(b)(1),(2),(3)

customers in a reliable, least cost manner. The FERC has authority over wholesale rates. The SEC has authority over RHC's financial securities, corporate structure, and non-power inter-affiliate transactions and over EHC variances from their exemptions. Although the bright line between federal jurisdiction at the wholesale level and state jurisdiction at the retail level resolves who has jurisdiction over a bulk power sale by investor owned utilities<sup>7</sup>, it does not resolve the preemptive effect of FERC wholesale rate orders over state regulation of retail rates.

This regulatory tension has been played out in the judiciary, because Congress has not addressed the issue directly. The filed rate doctrine, expressed in *Naragansett*, requires state commissions to treat FERC-approved wholesale costs as reasonable operating expenses for purposes of determining a utility's retail cost of service.<sup>8</sup> Under the *Pike County* doctrine, a state is not preempted from reviewing the prudence of a retail utility decision to purchase a particular quantity of wholesale power at FERC-approved rates when a utility has a choice among power purchase options.<sup>9</sup> Questions can be raised as to state commission power to review wholesale purchases between affiliates where these affiliates are captive within the holding company structure and thus lack the discretion to select other power sources. Under *Nantahala*, state commissions are preempted from trapping costs by preventing the full recovery in retail rates of a FERC-approved cost allocation among affiliates.<sup>10</sup> The Supreme Court extended this doctrine in *Mississippi*, to hold that states are preempted from prudence review of both a particular wholesale purchase involving FERC-approved allocations of specific quantities of power among subsidiaries of a holding company and the decision of those subsidiaries to invest in and bring on line or be a party to

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<sup>7</sup> The bright line provides that FERC has exclusive jurisdiction at the wholesale level as long as some portion of the sale is in interstate commerce and state action that unduly burdens or frustrates the exercise of federal regulatory power is preempted. *FPC v Southern California Edison*, 376 U.S. 205, 215-216 (1964)

<sup>8</sup> *Naragansett Electric Co v Burke*, 119 R.I. 559, 381 A. 2d 1358 (1977), *cert. denied*, 435 U.S. 972 (1978)

<sup>9</sup> In this case, the state commission did not question the reasonableness of the FERC approved rate, but whether the purchase was prudent in light of the availability of less expensive power from other sources. *Pike County Light & Power Co. v. Pennsylvania P.U.C.*, 465 A. 2d.735 (1983)

<sup>10</sup> *Nantahala Power & Light Co. v Thornburg* 476 U.S. 953 (1986)

agreements to construct and operate a shared generation facility.<sup>11</sup> In light of the judicial restrictions on state jurisdiction, the challenge of PUHCA reform is to capture the efficiencies of competition while preserving the legitimate regulatory protections embodied in the '35 Act.

## II Why PUHCA Reform is Here.

The purpose of amendments to PUHCA should be to provide lower cost electricity to consumers by promoting competition. First, increased competition in the generation sector, when equitably administered, can lower power procurement costs, encourage technological innovation, and have the potential to shift capital and operating risk from utilities to those parties more willing and able to bear this burden. Second, technological advances in the transmission of power create the potential for interconnection efficiencies between and among utility systems.

The current regulatory structure is inadequate to accommodate the changes in utility industry structure that will be necessary to realize these efficiencies. The existing regulatory model implicitly assumes vertically integrated investor owned utilities that each generate and distribute power primarily in one state. The modern reality is that the industry is restructuring into multi-state generation and regional transmission entities that sell to distribution systems which are still generally in one state.

The immediate problem is that PUHCA limits entry into the generation sector, while the U.S., even with aggressive energy conservation, will probably need 200 gigawatts of new generation capacity by 2010. Although Connecticut's aggressive energy conservation efforts and other factors postponed our need for new capacity until after 2000, we too will ultimately have to build new generation.

Under the '35 Act, a company seeking to invest in a single IPP might be able to qualify as an exempt holding company under Section 3(a).<sup>12</sup> However, PUHCA prevents a corporation from developing more than one

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<sup>11</sup> *Mississippi Power & Light v Mississippi ex rel Moore*, 108 S. Ct. 2428 (1988)

<sup>12</sup> Owners of a single IPP could seek exemption through one of the five provisions in Section 3(a). The commonly used exemptions are Section 3(a)(1), "intrastate exemption" and Section 3(a)(2) "predominantly a public utility."

IPP project, where the additional IPP projects are in different corporations and are located outside the developers "integrated public utility system."<sup>13</sup> The "second bite" rule effectively forecloses IPP developers that are not single corporations from undertaking multiple projects in geographically dispersed locations.<sup>14</sup>

Most potential entrants will not enter the generation sector if they are subject to extensive SEC regulation as a holding company.<sup>15</sup> In addition to geographical restrictions, the '35 Act places extensive restrictions on holding company financing, securities transactions, diversification, and inter-affiliate transactions.<sup>16</sup> Although PUHCA "doctors" have developed contorted corporate structures for IPP development, these legal acrobatics highlight the need for PUHCA reform to permit greater entry into the generation market.

To benefit the electric consumer, such entry must be equitably administered. All parties should have transmission access necessary to participate in the bulk power market as well as equal access to capital, and regulators must retain oversight capability to prevent abuses. From Connecticut's perspective, this raises five key issues which address the points raised in the Senator Dodd's letter:

1. PUHCA Reform Should Protect the Rights of State Commissions to Exercise Prudence Review over Purchased Power;

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<sup>13</sup> A single corporation could develop any number of projects anywhere in the country if all the IPPs remained within that sole corporation, because there would be no holding company.

<sup>14</sup> Section 9(a) requires SEC approval of any acquisition by "any person" if the acquisition would result in that person owning more than 5% of the voting shares of more than one public utility. In making its determination, the SEC will apply the criteria set forth in Section 10 which include whether the acquisition will lead to concentration of control; whether the purchase price is reasonable, and whether the transactions serves the public interest by tending towards the economic and efficient development of an integrated public utility system.

<sup>15</sup> If developers such as Westinghouse or Bechtel were determined to be electric utility holding companies, they would have to spin off their assets not related to the operating efficiencies of an integrated utility under Section 10. Clearly, they would not enter the market under such conditions.

<sup>16</sup> In brief, the '35 Act 1) requires SEC approval for sales of purchases of securities and utility assets, 2) restricts diversification, 3) requires conservative financing with thirty-five percent equity, 4) requires inter-affiliate transactions to be at cost, and 5) restricts geographic expansion by requiring a single integrated system.

2. PUHCA Reform should Protect the Effectiveness of State Commission Review of Affiliate Transactions;
3. Any PUHCA Reform providing Transmission Access to Enhance Competition should Recognize the Legitimate Economic Interests of Native Load Ratepayers;
4. PUHCA Reform should Enhance Fair Competition, not the Interest of Types of Particular Competitors;
5. PUHCA Reform should Preserve the Ability of the SEC and States to Protect Local Utilities against EWG Financial Losses.

### III. PUHCA Reform Should Protect the Rights of State Commissions to Exercise Prudence Review over Purchased Power

The multi-billion dollar decision to build a new power plant, purchase power from an EWG, or invest in alternative sources of energy, is the key determinant of electricity rates, long term financial risk, and environmental impacts. The state's review of these resource decisions is the cornerstone of its responsibility to protect retail ratepayers. Connecticut, along with other states, is a leader in Integrated Resource Planning policies which ensure that these decisions are made in the best interests of consumers. Without the unchallenged authority to review these decisions, as represented in *Pike County*, effective state regulation of retail rates is impossible. The original intent of the '35 Act was that SEC regulation under PUCHA should be complementary to state regulation.<sup>17</sup> PUHCA reform should reaffirm legitimate state authority in the modern setting, not undermine it.

Section 15106 of Title XV essentially codifies the existing judicial interpretation embodied in *Pike County* and *Mississippi*. I support the provisions in Title XV that affirm state jurisdictional authority over purchased power. However, Section 15106 need to be modified to clarify its vague prior approval provisions and remove loopholes.

Section 15106 (d)(1) appears to codify the *Pike County* doctrine provided that, at the request of the regulated utility, state commissions must make a prior determination of the prudence or imprudence of including the power purchase from an EWG into retail rates. First, there is no compelling reason why the language in Section 15106 should limit state commission authority to reviewing the prudence of power purchases only in the case of purchases from EWGs. Second, prior approval should mean a hearing process that may result in conditions under which power from EWGs may be

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<sup>17</sup> See generally Sections 6(b), 8, 9(f), 18, 19, and 20(b)



recovered. The bill language should be modified to reflect such meaning. State commissions simply can not be stripped of their ability to review the prudence of contract execution on an ongoing basis. Therefore, this section should clearly indicate that state commissions retain the power to review the prudence of utility management execution of the wholesale power contracts as well as future construction or operating costs of an EWG facility because such factors impact retail rates.

Section 15106 (d)(2) and (d)(3)(B) create a major loophole that, because of the proposed merger between Northeast Utilities (NU) and Public Service of New Hampshire (PSNH), is of immediate importance to Connecticut. Under the current language, if PSNH purchased power from an EWG affiliate and then subsequently sold or interchanged this power to CL&P, the Connecticut DPUC is expressly preempted from reviewing the prudence of CL&P's purchase (see Exhibit CT-4). If the purpose of these provisions is to permit central economic dispatch, then the language should be amended to preserve this benefit, while closing the loophole.

#### **IV. PUHCA Reform should Protect the Effectiveness of State Commission Review of Affiliate Transactions**

Since EWGs are not "electric utilities" within the meaning of the '35 Act, Title XV removes the oversight ability of the SEC under Sections 13, 14, and 15 to review the records of EWG inter-affiliate transactions.<sup>18</sup> Instead, Section 15105 extends FERC's current practice of addressing market power and other self dealing abuses while setting wholesale market-based rates to the additional setting of affiliate EWG rates. The self dealing abuses between affiliates that Connecticut is concerned about go beyond the more obvious preferential pricing behavior, to the subtler manipulation of non-price contract terms<sup>19</sup> and the potential for cross subsidization.<sup>20</sup> Therefore, state

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<sup>18</sup> SEC oversight ensures that the costs charged between affiliates are at cost of service. For example, within the registered holding company structure an operating company charges to an EWG affiliate for facility maintenance would be at cost of service, as would EWG fuel purchases from an affiliated company.

<sup>19</sup> In the case of Southern California Edison's (SCE) non-standard contract with its QF affiliate, Kern River Cogeneration (KRCC), KRCC was paid for higher valued long term firm capacity, when the contract terms permitted unlimited maintenance during on peak periods and low termination penalties that were more akin to lower valued "as-available" power. (see National Energy Strategy, Technical Annex No.1 p. 74-83 (1991/1992))

commissions need access to the books and records of EWGs to prevent self dealing abuses and to review the prudence of construction and operating costs.

Section 15108 addresses many state concerns over access to books and records, but needs to be clarified to prevent the more subtle manifestations of abuse. Specifically, Section 15108(a) limits state commissions' inquiry solely to the records of the EWG, not including the records of the parent company or other affiliates. As a result of the regulatory vacuum created by removing SEC oversight of inter-affiliate transactions, Section 15108 should be amended to provide for state commissions' access to the books and records of the EWG's affiliates and parent companies specifically on matters concerning contracts with the EWG, subject to confidentiality.

Congress should be cognizant of the additional administrative burden for state oversight in a more complex modern setting. While PUHCA reform still requires the states to protect consumers, it does not provide a funding mechanism to ease the strained budgets of state commissions. Any PUHCA reform should include a non-discriminatory funding mechanism to provide funds to state commissions for EWG oversight.

**V. Any PUHCA Reform Providing Transmission Access to Enhance Competition Should Recognize the Legitimate Economic Interests of Native Load Ratepayers**

In order to enhance competition in the generation sector, transmission access must be provided to all new entrants to allow them to reach buyers in the bulk power market. The Connecticut DPUC supports fair transmission access that recognizes the legitimate economic interests of native load ratepayers, who have supported transmission facilities in ratebase.

Transmission access should ensure that native load ratepayers are held harmless from third party wheeling by making those ratepayers whole for foregone economic transactions, and by ensuring that transmission rates are at least equal to incremental costs. To prevent native load ratepayers from enjoying any market power from their transmission systems, compensation for foregone economic transactions could be calculated by the FERC at the

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<sup>20</sup> Cross subsidization involves the provision of personnel and services from the regulated retail company to the unregulated EWG at below cost, effectively shifting costs and risks to ratepayers.

prevailing competitive price levels established in the bulk power markets. Making firm transmission capacity available in this way enhances efficient competition, by assuring transmission capacity will go to the highest valued use and protects against the exercise of market power.

Mr. Chairman, the July 1991 FERC Decision No. 364 in the proposed NU-PSNH merger, and the Connecticut DPUC's vigorous intervention in that case on behalf of our ratepayers, underscores the importance of this issue to Connecticut (see Exhibit CT-5).<sup>21</sup> Our ratepayers have spent millions of dollars to support transmission facilities, and should be able to realize the legitimate economic benefits associated with the use of those facilities. FERC Decision No. 364 would prevent Connecticut and New Hampshire ratepayers from realizing such benefits. The current legislative proposals in the U.S. Congress on transmission access do not yet embody fair recognition of legitimate ratepayer economic interests, and could permit flawed pricing principles similar to those in FERC Decision No. 364. On behalf of the Connecticut DPUC, I hope to work with you, Senator Dodd, this Committee, and other members of Congress on this important transmission access issue in the future.

#### **VI. PUHCA Reform should Enhance Fair Competition, not the Interests of Particular Types of Competitors**

Simply increasing the number of competitors, without providing equal opportunities to compete, does not enhance proper competition and will not benefit consumers. EWG status should not favor a specific type of power provider or create a privileged class of generators. As noted above, transmission owners need to provide fair access, not subsidies, to promote equality of opportunity. Similarly, to the extent that state commissions determine that high leverage does not present imprudent reliability or financial risks, simple utilities, EHCs, and RHCs should have equal access to the same leveraged capital structures as their non-traditional counterparts.

Connecticut supports the provisions in Section 15107 that affirm state authority to consider the prudence of a utility's power purchases from EWGs

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<sup>21</sup> Northeast Utilities Service Company, Opinion and Order Affirming in Part, Modifying in Part, and Reversing in Part Initial Decision and Conditionally Approving Disposition of Facilities, 56 FERC ¶ 61,296 (1991). The Initial Decision is reported at 53 FERC ¶63,020 (1990)

with highly leveraged capital structures and the impact of those purchases on reliability.<sup>22</sup> To the extent that state commissions find dependence on highly leveraged generation units to be imprudent, the SEC, in its analysis under Section 15101 (g)(3) and (4), should give these findings strong consideration in determining whether EWG financing or capitalization have a substantial adverse effect on the financial integrity of the RHC.

Title XV should, however, be amended to make the linkage of EWG rates to competitive markets explicit, by codifying current FERC policy denying flexible pricing authority unless it is shown that the seller has no market power (as modified by the discussion of transmission issues above). Section 15105 should be expanded to allow FERC to grant any EWG market based rates only upon a finding of competitive market conditions (absence of market power).

To create effective sanctions for anti-competitive actions by EWGs, Section 15101(g) should be expanded to allow the SEC to revoke the exemption of EWGs from PUHCA under the following circumstances:

1. The holding company has not established the appropriate means of determining allocation of costs between the EWG and the affiliate;
2. The EWG and affiliates have entered into abusive self dealing arrangements;
3. The EWG enters into an affiliate sales contract without the state approvals required under Title XV.

While these modifications serve to enhance competition, it is important to note that Congressional intent can be thwarted by inappropriate exclusion of existing utility generation units from competitive bidding processes of the states.<sup>23</sup>

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<sup>22</sup> These factors are but some of the criteria in considering the prudence of power purchases from EWGs, and the language in Section 15107 (8)(A)(iv) should in no way be construed to limit state commission discretion.

<sup>23</sup> In years past, many states restricted competitive bidding to QFs and IPPs to encourage the development of non-utility generation. However, now that electric utilities no longer have a monopoly on building new generation, and PUHCA reform would increase competition in the generation sector, it is clearly inappropriate for states to exclude existing utility generation from competitive bidding RFPs. This problem is especially pertinent to Connecticut, whose utilities have surplus capacity, and are effectively precluded from bidding in Massachusetts transitional RFPs for the next two years under the Massachusetts DPU decisions.

## **VII. PUHCA Reform should Preserve the Ability of the SEC and States to Protect Local Utilities Against EWG Financial Losses**

Since under Title XV, virtually any business could own an EWG, even those with other risky investments. If an EWG fell into bankruptcy or suffered severe financial losses, this can have profound implications for electric reliability and the states' ability to regulate retail rates.<sup>24</sup> An EWG's financial losses could push a utility holding company into financial distress, and an EWG could simply terminate service in that it does not have a obligation to serve except for its contractual promise.<sup>25</sup> Also, through loan guarantees or other mechanisms, a holding company could direct funds from its retail subsidiary, weakening its financial structure, and increasing its cost of capital. Therefore, Title XV should be modified to ensure that the SEC and state commissions have the authority to protect the financial integrity of utilities.

If a holding company or its utility subsidiary guarantee the securities of an EWG, such that there is a lien on assets, Section 15101(6)(g)(4) should be modified to consider this impact in the RHC's capital structure. Further, nothing in Section 15101 should be construed as preempting a state commission, acting under applicable state law, from considering the prudence of loan guarantees by a regulated utility subsidiary to an EWG.

## **VIII. Conclusion**

In conclusion, I support reform of the Public Utility Holding Company Act, but believe that passage of Title XV requires further careful and reasoned deliberation. In light of judicial restrictions on state jurisdiction, the challenge of PUHCA reform is to capture the efficiencies of competition while preserving core regulatory protections embodied in the original Act. Transmission access and the protection of legitimate native load economic interests are key issues that need to be addressed. In its deliberations over

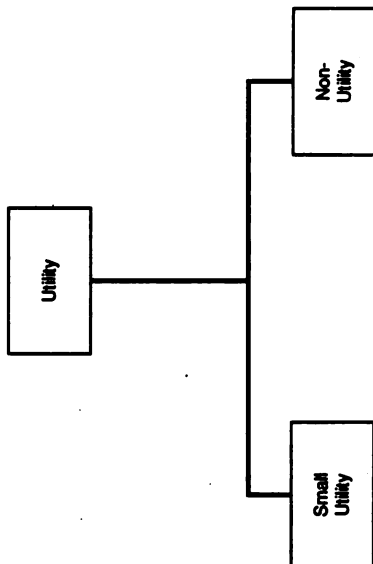
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<sup>24</sup> Section 15101 (1)(2) defines an EWG to be in the exclusive business of owning and operating an electrical generation facility. To the extent EWG diversification outside this context is allowed, SEC regulation under the '35 Act should apply.

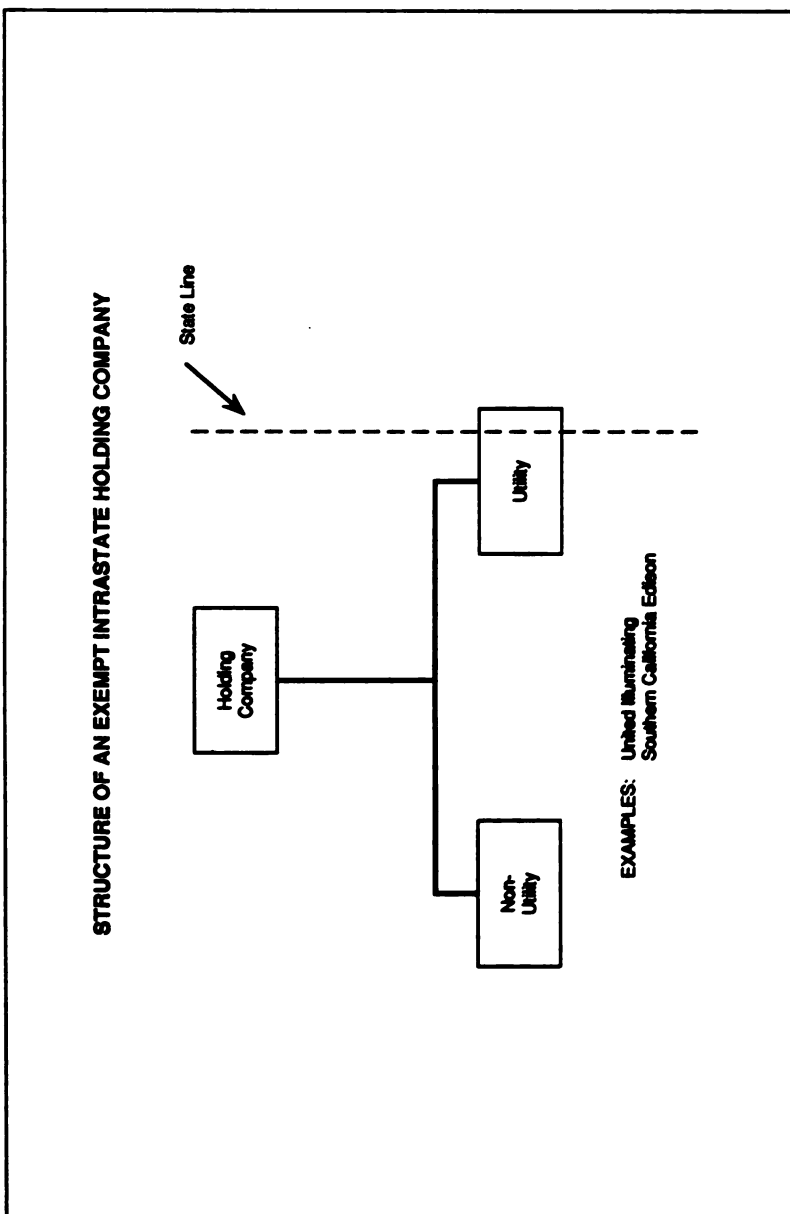
<sup>25</sup> Contract terms allowing utility takeover and operation of the plant could address the reliability problem posed by a bankrupt EWG, but not the impact on retail rates.

**Title XV, I know your subcommittee will thoughtfully consider the needed revisions and refinement, prior to passage of the first amendment of the Public Utility Holding Company Act since its adoption over fifty years ago.**

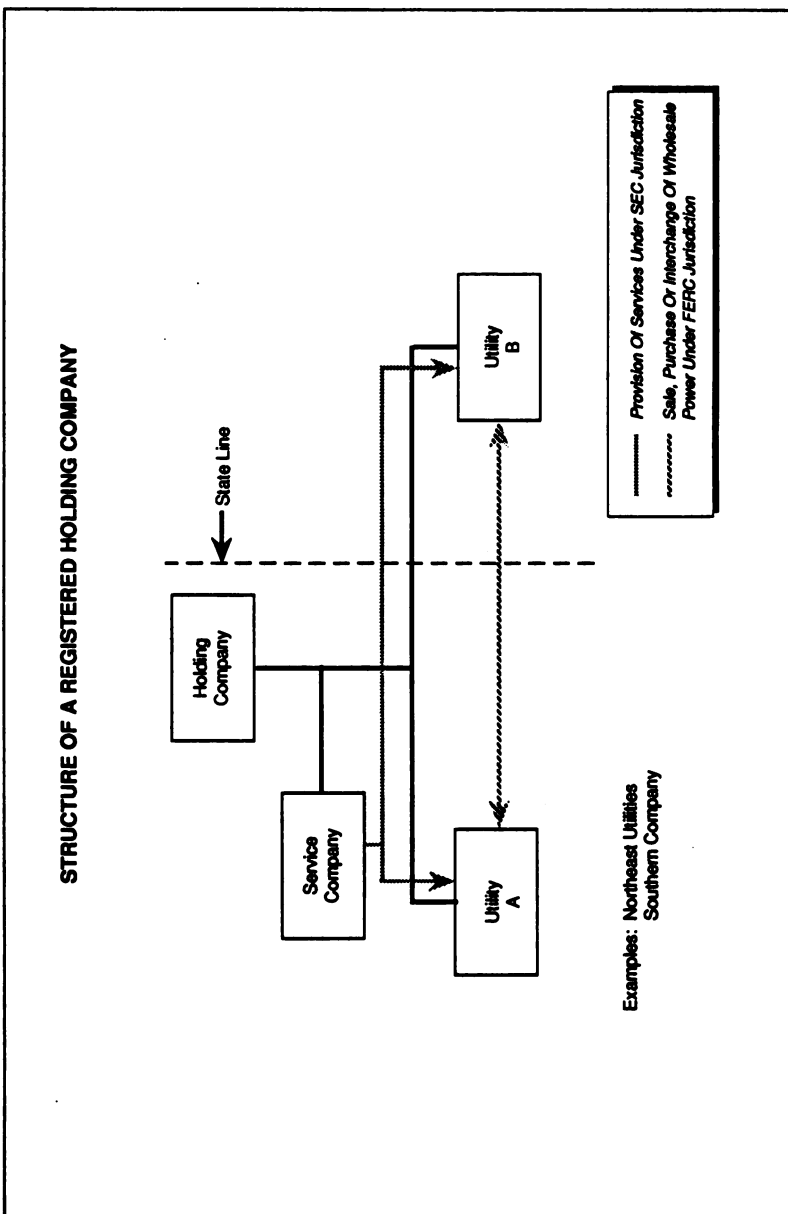
**STRUCTURE OF AN EXEMPT OPERATING COMPANY**



**EXAMPLES:** Connecticut Natural Gas  
Duke Power

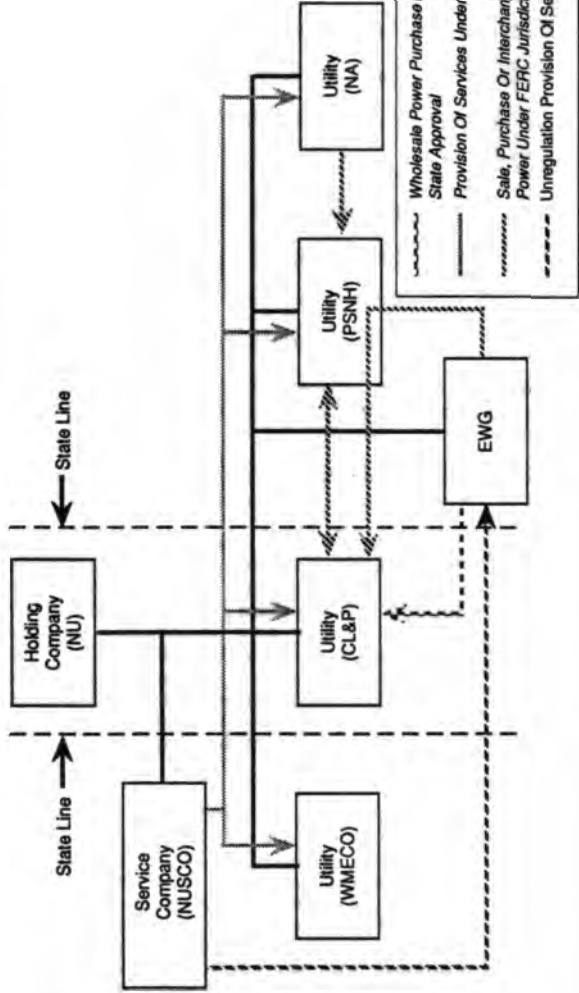






# REGULATORY LOOPHOLE IN EWG TRANSACTIONS BETWEEN AFFILIATES

Example: EWG in structure of Northeast Utilities after proposed merger with PSNH



## CONNECTICUT EXHIBIT 5

Connecticut urges the Commission to adopt a statement of principles, applicable in subsequent proceedings, that will afford Connecticut's native load ratepayers confidence that they will be made whole for yielding the economic use of the merged company's transmission to third-party wheeling.

**B. Recommended Conditions**

**1. Native Load Safeguard Conditions**

On rehearing the Commission should adopt the following Native Load Safeguard Conditions:

**NU operating companies that own transmission facilities need not make firm transmission capacity available to a requesting party, if NU establishes --**

- **the capacity is necessary to maintain reliability for native load customers, or**
- **the capacity is necessary for reasonably foreseeable economic power purchases that will reduce the revenue requirement used to determine native load rates, unless the requesting party agrees to pay the operating company that owns the facilities an increment to the transmission rate that will recover the amount by which the cost to the operating company of substitute power (from its own system or other purchase exceeds the cost of economy purchases it must forego in future transactions, or**
- **the capacity is necessary for reasonably foreseeable off-system sales, the proceeds of which would be credited against the revenue requirement used to determine native load rates, unless the requesting party agrees to pay the operating company owning the facilities an increment to the transmission rate that will recover the portion of the proceeds of the foregone sale that would have been so credited, or**
- **the use of the capacity would impose on the NU operating company identifiable incremental costs, unless the requesting party agrees to pay the**

operating company an increment to the transmission rate that will recover such incremental costs.

The NU operating company must credit any such transmission rate increment against the revenue requirement used to determine native load rates.

In proceedings to implement the Safeguard Conditions, the Commission can cap any transmission rate increment for foregone economic transactions at competitive price levels established in New England bulk power markets. In this way, recovery for the loss of benefits from such transactions cannot be affected by any market power the merged company may have. The CDPUC does not seek to preserve for its native load ratepayers the fruits of any market power that may exist with or without the merger.

The Commission may also wish to consider allowing a requesting party to elect either (i) a variable increment to its transmission rate based on purchases or sales actually foregone in the future, or (ii) a fixed increment to its transmission rate based on NU's reasonable current estimate of future foregone sales and purchases. In the event the requesting party elects a variable transmission rate increment, NU would be required to provide documentation of any foregone sale or purchase on which it bases such increment.



**MICHIGAN MUNICIPAL COOPERATIVE  
GROUP MEMBERS**

**Municipalities:**  
Bay City  
Charlevoix  
Chatham  
Easton Rapids  
Grand Haven  
Harbor Springs  
Hart  
Holland  
Lansing  
Livonia  
Plymouth  
Port Huron  
St. Louis  
Traverse City  
Zeeland

Michigan Municipal Electric Association  
Michigan Public Power Agency  
Michigan South Central Power Agency  
Ingersoll Electric Cooperative  
City of Coleman  
City of Marshall  
City of Marshall  
Wolverine Power Supply Cooperative  
Cherryland Electric Cooperative  
O & A Electric Cooperative  
Owosso Electric Cooperative  
Piquette Lake Electric Cooperative  
Rural Michigan Electric Company  
St. Joseph Electric Cooperative  
Western Michigan Electric Cooperative

**SUMMARY OF TESTIMONY OF GARY ZIMMERMAN  
ON BEHALF OF THE  
MICHIGAN MUNICIPAL COOPERATIVE GROUP  
AND  
AMERICAN PUBLIC POWER ASSOCIATION  
NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION  
AND  
FLORIDA MUNICIPAL POWER AGENCY  
NORTH CAROLINA EASTERN POWER AGENCY  
NORTH CAROLINA MUNICIPAL POWER AGENCY NO. 1  
ELECTRICITIES OF NORTH CAROLINA, INC.  
MICHIGAN ELECTRIC COOPERATIVE ASSOCIATION  
ALLEGHENY ELECTRIC COOPERATIVE  
AMERICAN MUNICIPAL POWER - OHIO  
OHIO MUNICIPAL ELECTRIC ASSOCIATION  
CENTRAL MINNESOTA MUNICIPAL POWER AGENCY  
KANSAS MUNICIPAL UTILITIES, INC.  
KANSAS MUNICIPAL ELECTRIC AGENCY  
ILLINOIS MUNICIPAL ELECTRIC AGENCY  
COLORADO ASSOCIATION OF MUNICIPAL UTILITIES  
VIRGINIA MUNICIPAL ELECTRIC ASSOCIATION  
BEFORE THE  
SECURITIES SUBCOMMITTEE  
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS  
UNITED STATES SENATE  
SEPTEMBER 17, 1991**

**MMCG Members provide electricity to more than one million Michigan residents.**

My name is Gary Zimmerman. I'm Executive Vice President of the Michigan Municipal Electric Association. I'm testifying on behalf of:

- Municipally and cooperatively owned utilities who serve over 1 million Michigan residents and similar utilities in Florida, North Carolina, Pennsylvania, Ohio, Minnesota, Kansas, Illinois, Virginia and Colorado.
- The American Public Power Association and the National Rural Electric Cooperative Association. Their member utilities provide 25% of the U.S. population with electricity.

Municipal and cooperative utilities are concerned about the exemption from the Holding Company Act in S. 1220 for exempt wholesale generators (EWG's) for two reasons. First, some of our utilities buy much of their electricity from other utilities and want to prevent unnecessary increases in the electric rates they pay. We want real competition in the power purchases of the utility we buy from and no "self-dealing" between it and affiliated EWG's. Second, our utilities want a fair and equal opportunity to buy from EWG's that are offering an attractive price. Any exemption for EWG's must have three things to address these concerns and promote true competition. Otherwise electric rates will go up unnecessarily:

- a ban on purchases by utilities from affiliated EWG's,
- a granting of EWG exemptions only on a case-by-case basis--no blanket exemptions, and
- provisions for participation in the electric transmission system for all utilities on an equal basis.

**Self-Dealing:** The Michigan experience shows what is likely to happen nationwide if you pass S. 1220 without these protections. The Act was passed partly to prevent abusive transactions between utilities and their affiliates that mainly drive up electric rates. But the "self-dealing" transactions between Consumers Power and its Midland Cogeneration Venture (MCV) and Palisades Generating Company affiliates show a utility buying high-priced electricity from largely deregulated affiliates so as to increase the profits of its corporate parent. They show that the protections of the Act are still needed.

Consumers Power wants to pass on to its customers the full amount it will pay its affiliates for electricity. If Consumers Power succeeds the result will be at least \$8 billion dollars in increased rates compared to what rates would be if the affiliates' plants were owned and operated by Consumers Power as ordinary utility plants. Much of the \$8 billion ends up as extra profits to Consumers Power's corporate parent, CMS Energy, which owns the largest stake in the affiliates. \$8 billion is enough to give free electricity to each of Consumers Power's customers for over four years! Some idea of the self-dealing is shown by the following:

- The major abuse on the MCV was in trying to convert a nuclear plant to a natural gas fired generating plant. Converting a nuclear plant to a gas plant is about as cost-effective as trying to convert the space shuttle into a Boeing 737--it's far cheaper to scrap the shuttle and build the airplane from scratch. The MCV cost \$2.3 billion, which is paid for in the rate at which it sells electricity to Consumers Power. But for one-third the cost--\$800 million--Consumers Power could have built a conventional gas-fired generating plant of the same size. But Consumers Power chose to create the MCV and buy electricity from it even though this alone would cost its customers \$1.5 billion more than building a conventional, regulated, utility-owned gas plant.
- Consumers Power chose the MCV "nuclear to gas" conversion route because this would effectively allow it to force its customers to pay \$1.5 billion more for the abandoned Midland Nuclear Plant than the \$760 million which the Michigan Public Service Commission has ruled is all its customers should pay towards that plant.
- Consumers Power rejected offers of lower-priced electricity from independent cogenerators in order to purchase more expensive electricity from its two affiliates.

S. 1220 must be amended to have a total ban on purchases by--and other significant transactions between--utilities and affiliated EWG's. Michigan's experience shows the risks of billions of dollars in overcharges from affiliate purchases is too great; self-dealing is very difficult for regulators to police because they are outnumbered and always playing catchup; and as Consumers Power has been able to argue with some success, the regulators lack the authority to deal with some of the abuses.

Case-by-Case: Michigan's experience shows the risk of abuses that were not anticipated when Congress created the exemptions that the MCV is now trying to use. Any EWG exemptions should be granted on a case-by-case basis, if at all, after notice and a hearing. This will result in exemptions being carefully tailored and conditioned to the specifics of a particular situation to prevent abuses, including those we cannot now anticipate.

Transmission: Transmission is essential to competition to supply electricity in the same way that access to the highways is essential to competition between manufacturers. Giving utility affiliates exemptions from the Act without giving all utilities equal transmission access will permit dominant transmission controlling utilities to foreclose competition. Their EWG affiliates can then sell electricity into utility controlled monopoly markets at inflated prices that will cost the public billions of dollars and lead to excessive deregulated profits for the EWG's.

This can occur because the transmission lines in each region

are coordinated, planned and built by the dominant utilities that own the lines. They are usually accompanied by agreements that give them reciprocal transmission rights over each other's lines. But the smaller utilities, who serve roughly 25% of the U.S. population, are largely excluded from such planning and rights. You can't have true competition for electricity supplies from EWG's or others with this many of the players excluded.

Our history shows this. Our utilities have been seeking the lowest cost sources of electricity for decades. The biggest factor hindering us in this has been transmission--our utilities own few transmission lines. The dominant utilities who own the lines would prefer we buy electricity from them. They deny or restrict our usage of the lines to try to force us to buy from them. For example, although Consumers Power has a transmission rate available, it is good only a week at a time and thus can't be counted on for long-term purchases from EWG's or others. So creating EWG's will not do much to increase electricity supplies or competition when for decades we have had great difficulty buying from existing sources. Creating EWG's will help only if transmission, which is the limiting factor, is addressed.

Creating deregulated EWG's without addressing transmission may well increase electric rates to us and to all customers because the dominant transmission owning utilities will have great incentives to place their new generation in deregulated affiliates. Their affiliates can then sell electricity into the monopoly markets controlled by their utilities at above-cost rates. The dominant utilities can thus use their transmission control to prevent competition and to increase rates to all customers to the detriment of our economic competitiveness and well-being. Thus the key to true competition in electricity supplies is equal transmission access for all utilities.

A simple way to provide equal access is to allow all utilities to participate equally in the current multiple ownership of the regional transmission grid, including its planning, development, usage and reciprocal rights. Arrangements similar to this currently exist in portions of New England, Indiana, Texas, Georgia and Wisconsin and various national groups are proposing similar plans. Other ways can work, too, if they lead to all utilities having access to the transmission system on equal terms. And Congress should clarify that the Federal Energy Regulatory Commission may order the dominant privately-owned utilities that control the transmission grids to provide municipally and cooperatively owned utilities transmission services on non-discriminatory rates, terms and conditions. This will give the smaller utilities transmission on a basis which is economically and functionally equivalent to the use of the transmission system available to the dominant privately-owned utilities and their affiliates.

The key to the exemption in S.1220 is equal transmission access. Without it you will not increase competition in electric generation and may cause unnecessary rate increases.





**TESTIMONY OF GARY ZIMMERMAN**

**ON BEHALF OF THE**

**MICHIGAN MUNICIPAL COOPERATIVE GROUP**

**AND**

**AMERICAN PUBLIC POWER ASSOCIATION**

**NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION**

**AND**

**FLORIDA MUNICIPAL POWER AGENCY**

**NORTH CAROLINA EASTERN POWER AGENCY**

**NORTH CAROLINA MUNICIPAL POWER AGENCY NO. 1**

**ELECTRICITIES OF NORTH CAROLINA, INC.**

**MICHIGAN ELECTRIC COOPERATIVE ASSOCIATION**

**ALLEGHENY ELECTRIC COOPERATIVE**

**AMERICAN MUNICIPAL POWER - OHIO**

**OHIO MUNICIPAL ELECTRIC ASSOCIATION**

**CENTRAL MINNESOTA MUNICIPAL POWER AGENCY**

**KANSAS MUNICIPAL UTILITIES, INC.**

**KANSAS MUNICIPAL ELECTRIC AGENCY**

**ILLINOIS MUNICIPAL ELECTRIC AGENCY**

**COLORADO ASSOCIATION OF MUNICIPAL UTILITIES**

**VIRGINIA MUNICIPAL ELECTRIC ASSOCIATION**

**BEFORE THE**

**SECURITIES SUBCOMMITTEE**

**COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS**

**UNITED STATES SENATE**

**SEPTEMBER 17, 1991**

**MICHIGAN MUNICIPAL COOPERATIVE  
GROUP MEMBERS**

**Municipalities:**

Bay City  
Charlevoix  
Chatham  
Easton Rapids  
Grand Haven  
Harbor Springs  
Hart  
Holland  
Lansing  
Lowell  
Potoskey  
Portland  
St. Louis  
Traverse City  
Zeeland

**Michigan Municipal Electric Association**

**Michigan Public Power Agency**

**Michigan South Central Power Agency**

**Village of Cass**

**City of Cadillac**

**City of Holland**

**City of Marshall**

**Village of Union City**

**Wolverine Power Supply Cooperative**

**Cherryland Electric Cooperative**

**O & A Electric Cooperative**

**Oakland Electric Cooperative**

**Presque Isle Electric Cooperative**

**Big O' Michigan Electric Company**

**30-County Electric Cooperative**

**Western Michigan Electric Cooperative**

**MMCG Members provide electricity to more than one million Michigan residents.**

## TESTIMONY OF GARY ZIMMERMAN

Mr. Chairman, Members of the Committee:

Thank you for allowing me to testify today. My name is Gary Zimmerman. I'm Executive Vice President of the Michigan Municipal Electric Association and a member of the Steering Committee of the Michigan Municipal Cooperative Group. For the last 17 years I've been in the electric utility business, first as the manager of a city electric utility and then as the manager of power supply authorities that supply electricity to several municipally-owned utilities.

Today I'm testifying on behalf of:

- The Michigan Municipal Cooperative Group and essentially all of Michigan's municipally and cooperatively owned utilities. Collectively, these utilities provide electricity to over 1 million Michigan residents.
- The American Public Power Association and the National Rural Electric Cooperative Association. These are the national associations for cooperatively owned and municipally owned electric utilities. Their members provide 25% of the U.S. population with electricity.
- Municipally and cooperatively owned utilities in Florida, North Carolina, Pennsylvania, Ohio,

Minnesota, Kansas, Illinois, Virginia and Colorado.

Municipal and cooperative utilities are non-profit and are owned by the customers they serve. Electric cooperatives mainly provide electric service to people in rural areas. There are about 1,000 cooperatives nationwide serving 10% of the U.S. population. Municipal electric utilities are owned by a city, village or other governmental unit and provide electricity in the municipality and nearby areas. There are approximately 2,000 municipal utilities nationwide serving 15% of the U.S. population. Examples include the cities of Orlando, Austin, Sacramento and Colorado Springs.

Municipal and cooperative utilities are concerned about the Holding Company Act exemption in S. 1220 for two reasons. First, some of our utilities buy much of their electricity from utilities such as Detroit Edison or Consumers Power. We want to prevent unnecessary increases in the electric rates we pay. For that reason we want real competition in the power purchases of the utility we buy from and want to prevent "self-dealing" between that utility and affiliated generating companies.

Second, if Congress is going to pass S. 1220 and create a new class of power plants known as exempt wholesale generators (EWG) then we want to make sure that our utilities have a fair and equal opportunity to buy from them. We don't want to be artificially prevented from purchasing electricity from an EWG who is offering us an attractive price.

Need for an Exemption: By way of background there is a range of views among municipal and cooperative utilities on whether an

exemption from the Holding Company Act for EWG's is necessary. In part this is because to date when utilities have asked for bids to supply them with electricity many "cogenerators" have responded. Cogenerators are exempted by a 1978 law from the Holding Company Act. Most bids have led to cogenerators' offering 3 to 10 times more electricity than the utility needs. The resulting competition has led to very attractive prices for the purchasing utility.

As a result some municipal and cooperative utilities question whether another exemption from the Holding Company Act is really needed. This is especially the case given the risk another exemption will create abuses that may drive up electric rates.

Instead, many of our utilities believe that increasing all utilities' ability to use the electric transmission system by itself will help keep electric rates down by increasing the competition to provide new sources of power and will help keep adequate electric supplies available. It would avoid the risks of unnecessary rate increases caused by creating another exemption to the Holding Company Act.

Amendments Needed to S. 1220: However, all the utilities I'm testifying for agree that if Congress is going to amend the Holding Company Act to create "exempt wholesale generating companies" then at least three things have to be present to increase competition and prevent electric rates from going up unnecessarily:

- a ban on purchases by utilities from affiliated EWG's,
- a granting of EWG exemptions only on a case-by-case basis--no blanket exemptions, and

-- provisions for equal participation in the electric transmission system for all utilities so as to promote true competition.

Title XV of S. 1220 does not have these protections. Our experience in Michigan, especially with utility affiliates, shows why they are needed.

This is because Michigan, along with California, is the principal state where a utility has purchased large amounts of electricity from its own "cogeneration" affiliates. Qualifying cogenerators are exempted from the Holding Company Act in much the same way as EWG's would be under S. 1220. Michigan has found substantial abuses and self-dealing on these purchases from cogeneration affiliates. California has found the same. The abuses harm competition and drive up electric rates. Michigan has the first proposed nuclear EWG in the country and it has similar abuses.

These experiences indicate what is likely to happen nationwide if you pass S. 1220 in its current form. I am here today to describe these experiences and to indicate in light of them what changes are needed to Title XV of S. 1220 to truly promote competition and prevent unnecessary increases in electric rates.

Self-Dealing

Consumers Power Company has signed contracts to buy large amounts of electricity from two affiliates. One, the Midland Cogeneration Venture (or MCV), Consumers Power contends is deregulated because it is a cogenerator. The other, the Palisades Generating Company, is a would-be nuclear wholesale generating company which Consumers Power contends will effectively be deregulated.

Consumers Power is seeking to pass on to its electric customers the full amount it will pay its affiliates for electricity. If it succeeds, based upon testimony submitted to the Michigan Public Service Commission, the result may be up to \$8 billion dollars in extra rate increases compared to what rates would be if the affiliates' plants were owned and operated by Consumers Power as ordinary utility plants. These increases aren't necessary.

Much of this \$8 billion ends up as extra profits to Consumers Power Company's corporate parent, CMS Energy, which owns the largest stake in the two affiliates. Parts of the \$8 billion go to other companies that own part of the affiliates--Bechtel, Westinghouse and Fluor-Daniel to name a few.

To put these sums in perspective, the \$8 billion will accumulate over the life of the two contracts. But the amounts are huge--\$8 billion is enough to give free electricity to each of Consumers Power's customers for over four years! Looked at another way \$8 billion is the same as doubling Consumers Power's electric

rates for over 4 years--which more vividly describes the effects of Consumers Power's self-dealing. And, in addition to the \$8 billion in rate increases Consumers Power has been trying to transfer over \$2 billion in assets from the utility to its corporate parent.

California has had similar problems in power purchases by the Southern California Edison Company from its cogeneration affiliate.

These transactions show the general "self-dealing" strategy of Consumers Power Company, namely buying high-priced electricity from deregulated affiliates so as to increase the profits of its corporate parent. One of the reasons the Holding Company Act was passed in the 1930's was to prevent abusive transactions between utilities and their affiliates that mainly drive up electric rates. The transactions between Consumers Power Company and its Midland Cogeneration Venture and Palisades Generating Company affiliates show that the protections of the Holding Company Act are still needed and that S. 1220 has to be amended to have a total ban on transactions between utilities and their EWG affiliates. Let me describe the two Consumers Power affiliates and the abuses with each in more detail.

**MCV:** The Midland Cogeneration Venture is a large electric generating plant principally owned by CMS Energy, Consumers Power's parent company. It was planned and put together by Consumers Power Company using assets from Consumers Power's abandoned Midland Nuclear Plant. The MCV burns natural gas as its fuel and signed a long-term contract to sell its electricity to Consumers Power

Company. The MCV has received Federal Energy Regulatory Commission (FERC) certification as a qualifying "cogenerator" which we and the State of Michigan are challenging in the courts. If upheld such certification will exempt the MCV from the Holding Company Act, will allow it to sell electricity at prices far higher than if it were a power plant owned outright by Consumers Power Company and will prevent the MCV's profits from being regulated.

Some idea of the self-dealing and excess costs Consumers Power is trying to pass on to its customers are shown by the following.

- The major abuse on the MCV was the decision to convert a nuclear plant to a natural gas fired generating plant as opposed to having Consumers Power build an ordinary gas-fired utility plant. Converting a nuclear plant to a gas plant is about as cost-effective as trying to convert the space shuttle into a Boeing 737--it's far cheaper to scrap the shuttle and build the airplane from scratch. The MCV cost \$2.3 billion, which is paid for in the rate at which it sells electricity to Consumers Power. But for one-third the cost--\$800 million--Consumers Power or one of our utilities could have built a conventional gas-fired generating plant of the same size. But Consumers Power chose to create the MCV and buy electricity from it even though this would cost its customers \$1.5 billion more than building a conventional, regulated, utility-owned gas-fired generating plant.
- Consumers Power chose the MCV "nuclear to gas" conversion route because this would effectively allow it to force its



customers to pay \$1.5 billion more for the abandoned Midland Nuclear Plant than the \$760 million which the Michigan Public Service Commission has ruled is all its customers should pay towards that plant. It works this way: Consumers Power "sells" parts of its abandoned Midland Nuclear Plant to the MCV for \$1.5 billion. Consumers then sends the \$1.5 billion to its unregulated corporate parent, CMS Energy. The MCV's \$1.5 billion purchase is reflected in the high rates Consumers Power pays the MCV for electricity and which Consumers Power simply passes on to its customers in the rates it charges them. The result is a \$1.5 billion nuclear overcharge to Consumers Power's customers. And to give you some idea just how "useful" the nuclear plant was to the MCV, part of what it bought was millions of dollars of consulting services done years ago to see whether soil conditions beneath buildings which Consumers Power still owns met nuclear requirements!

-- For Consumers Power's strategy with the MCV to work, it had to fend off any attempts by truly independent cogenerators to sell it electricity at a lower price than the MCV's. And that's exactly what it did: Our Public Service Commission held a proceeding to see who besides the MCV would offer to sell electricity to Consumers Power. Nearly 100 projects offered to sell electricity. The total amount of power offered was three times what Consumers Power needed. Several--including James River Paper Company, Dow Chemical, and the owners of a retired Consumers Power generating plant--offered

much lower prices than the MCV. In similar situations around the country where utilities have been offered far more electricity than they could use they have negotiated for the best price or set up a bid process to get the best price possible. But Consumers Power didn't do this. Instead it rejected out of hand the lower-price offers and insisted that it had to buy from its MCV affiliate at the highest price possibly allowed by law!

- Consumers Power has continued to be successful in holding off truly independent cogenerators who might offer lower prices which Consumers would have a hard time plausibly rejecting in favor of high-priced purchases from its affiliates. This is shown by the fact that last year over 90% of its cogeneration purchases were from sister companies.
- When our Public Service Commission reviewed the MCV contract it apparently felt its hands were tied due to some prior rulings that prevented them from directly addressing the Consumers Power abuses. Certainly Consumers Power took the position that the MPSC didn't have jurisdiction to do anything except look at the rate in the contract, couldn't look at any abusive practices and couldn't order Consumers Power to buy from less expensive suppliers. The key is that the MPSC lowered the rate to be paid the MCV and phased it in over time. Consumers Power has now taken the MPSC to court arguing that it has to pay more for the electricity from the MCV than the MPSC allowed. That speaks volumes--how often have you

seen a buyer go to court arguing that the price it was paying was too low! Consumers Power wouldn't be arguing this except that the more it pays the MCV, the bigger the profits for CMS Energy, which owns Consumers and much of the MCV.

-- Consumers Power's self-dealing with the MCV was not limited to the electric area--the gas contracts for the MCV are also set up on a "sweetheart deal" basis that may cost the gas utility customers of Consumers Power millions of dollars each year. Consumers Power is both a gas utility and an electric utility. Its gas utility employees made the natural gas purchases for the supposedly "independent" gas-fired MCV at the same time they were purchasing natural gas for the Consumers Power gas utility. The result was 10 pairs of long-term contracts to buy gas from gas producers in the U.S. and Canada--10 for Consumers Power and 10 for the MCV. Both contracts in each pair were much the same except for the price. The Michigan Public Service Commission found that each pair of contracts was negotiated as a "package deal" where "Consumers Power agreed to pay more than the asking price in exchange for a below-the-asking price rate for the MCV". Giving the lower-priced gas to the MCV increases the MCV's profits and the cost of the higher-priced gas purchased by Consumers Power would normally be passed on directly to its gas customers.

-- The person who supposedly represented the MCV when it "negotiated" its contract to sell electricity back to

Consumers Power Company in fact was paid by Consumers Power during much of the negotiations. Although he supposedly was negotiating for the MCV, during the negotiations he reported to and was directed by a Vice President and then by the Executive Vice-President of Consumers Power Company. And the responsibility in the negotiations for deciding what terms were acceptable to the MCV rested with the Vice President or Executive Vice-President of Consumers Power!

-- This pattern of being on both sides of the table continued such that when Consumers Power came back empty-handed after being told by our Public Service Commission to renegotiate key aspects of the MCV contract that the PSC said, "One must wonder whether Consumers Power has once again negotiated with itself and lost."

Palisades: Palisades is a Consumers Power nuclear plant that has been operating since the 1970's. Consumers Power is attempting to sell the plant and related transmission lines to a sister company called the Palisades Generating Company, which is owned by Consumers Power and two non-utility companies. Consumers Power has agreed to buy the electricity from the plant under a contract that runs through the year 2006. The owners of Palisades Generating Company, including Consumers Power, CMS Energy and Bechtel Power Corporation, have applied to the SEC for a no-action letter or other determination that they would be exempt from the Holding Company Act. They shouldn't get it.

Some of the specifics on this transaction are as follows.

- The contract may result in Consumers Power's customers paying over \$7 billion for electricity from the plant through the year 2006 if the plant achieves the good operating levels it expects. The actual cost to generate the electricity, using Consumers Power's and its affiliates' cost estimates and including a reasonable profit, should be around \$5.5 billion. The more than \$1.5 billion difference is essentially all excess profit.
- Much of the excess profit and corresponding excess charges to Consumers Power's customers relates to the amount of time the plant operates. To date the plant has operated poorly--only about 45% of the time. Typical plants operate 65% of the time and good ones reach the mid-70%'s. Consumers Power claims that the plant's performance won't improve without an "incentive" to do so and wrote the contract so that the affiliate gets a bonus the more the plant exceeds a 55% level. BUT why use 55% when even an average plant reaches 65%--the 10 percentage point difference is a guaranteed bonus. And Consumers Power's own documents show they believe the plant will operate at levels far better than 65%.
- Most important, Consumers Power will continue to operate the plant even after it is sold: It has already signed a contract to operate the plant for its sister company for at least three to five years. In Federal testimony the sister company said it has no employees now and is expected to have only a handful in the future. So this is really only a paper transaction--

why can't Consumers Power clean up its act and operate the plant properly now without its ratepayers risking paying billions more?

- Power plants are usually most expensive during their early years when mortgage payments and depreciation charges are high, and when the bugs are being worked out. They are often most economic in their later years when they are running well and have been largely paid for. Here, on the Palisades plant Consumers Power wants its customers to bear the brunt of the costs and risks of the plant in its first two decades and then wants its shareholders to have all the benefits of the remaining several decades of the plant's life. This is unfair and very expensive to Consumers Power's customers, because the plant will likely be useful and economic for decades after the proposed contract expires in the year 2006. In effect Consumers wants its customers to pay for a whole jug of milk, but gives the customers only the skim milk while Consumers Power takes the cream.

General: Consumers Power's self-dealing and other actions have united against it in its rate cases and other litigation its industrial customers (GM and the like), its residential customers, other utilities, our Attorney General, the Consumers Power labor union and the Public Service Commission. None of these diverse groups supports S. 1220 in its present form and most are actively opposed to it or requesting changes. The opposition of these widely varied groups further shows the need for the kinds of

amendments to the Holding Company Act exemption provisions of S.1220 we are recommending.

Much of what I have described about the MCV is set forth in detail in lengthy Michigan Public Service Commission orders. I have attached excerpts from our Public Service Commission's testimony on Holding Company Act reform before Representative Sharp's Subcommittee this spring because there the PSC included key excerpts from their rulings on transactions between Consumers Power and its affiliates.

California: California has had similar experiences with self-dealing between the Southern California Edison Company and its cogeneration affiliates. Last year the California Public Utility Commission found that in just three years that utility paid about \$50 million too much to one of its affiliates and disallowed the utility's attempts to pass those sums on to its customers. The Commission noted the conflict due to the fact the utility personnel ostensibly negotiating for the utility on the contract in question were officers of the affiliate the utility was buying from.

And last December an Administrative Law Judge at the Federal Energy Regulatory Commission rejected a proposed merger involving Southern California Edison in part due to the preceding self-dealing abuse, evidence suggesting other similar abuses and a finding that potential remedies were inadequate to prevent future abuses.

Self-Dealing--Remedy: Consumers Power's actions with its affiliates and the experiences in California show that if utilities

are allowed to engage in transactions with unregulated affiliates this will lead to massive self-dealing that unnecessarily increases electric rates. And they show that such self-dealing is very difficult for even the best-intentioned regulators to police after the fact. This is for several reasons: With billions of dollars at stake the temptations are too great; The downside risks from getting caught are low--your excess profits are taken away from you but you don't actually lose money; What one regulator or lawmaker creates as a barrier clever managers, investment bankers and lawyers can find ways around: And the regulators and legislators are outgunned and always playing catchup--plugging last year's loophole while the affiliates are creating new ones. And S. 1220 is ineffectual in its provisions that purport to ban abusive self-dealing. In fact it appears to specifically condone some of the abusive practices we've seen with Consumers Power.

For example, S. 1220 specifically allows some self-dealing between a utility and its EWG because only "undue advantages" granted the affiliate EWG are curtailed by the bill. And only a few types of "advantages" disqualify and EWG, namely only those in the "rate or charge" paid the EWG for electricity.

What utilities such as Consumers Power will surely argue is that a utility can refuse to deal with independent EWG's and buy only from its affiliates so long as it doesn't offer different rates to the two. So the kinds of refusals to buy from lower-cost competitors which Consumers Power has engaged in as a key part of its affiliate self-dealings may be allowed by S. 1220! There are



other serious problems with this part of the bill, but the preceding is sufficient to show why it cannot be taken seriously.

For these reasons we believe that any amendments to the Holding Company Act must contain an absolute ban on any exemptions for EWG's that are in any way affiliated with a utility they sell power to or have any significant transactions with. And the SEC and its staff have to be prohibited from end-running this prohibition by issuing so-called "no-action letters" or the like.

Partial prohibitions, or exemptions only if a state allows it won't work. In Michigan we've seen that the regulators--both state and Federal--don't have the necessary legal tools to adequately regulate this area. Consumers Power has repeatedly challenged attempts at the Michigan Public Service Commission or the Federal Energy Regulatory Commission to address abuses by it or its affiliates on the ground that the Commissions' don't have the legal authority to look into these matters. And much too often the Commission's or courts have agreed with Consumers Power on this. So in plain English our experience has shown there is a large risk of utilities finding loopholes or regulatory gaps that allow abuses with their affiliates to go unchecked. As Michigan Public Service Commissioner Ronald Russell has said, Michigan's experience with CMS Energy and its subsidiaries show that, with complex holding company structures, "transactions between corporate affiliates can be manipulated to embrace the concept of competitive generation while ensuring that all competitive advantages reside with holding company affiliates."

Such a ban should not be a problem. It is my understanding that at this point most utilities that want to get into the independent power business are willing to pass on doing business in their state in order to be able to work in the other 49 states. Some of these have indicated that they don't want to do business with their own affiliates because they will be perceived as engaging in sweetheart deals even if that's not the case.

Case-by Case Exemption

Our experience also shows the severe risks of a blanket exemption from the Holding Company Act or other protective statutes when entering a new area. There is a significant risk that abuses may occur which were not anticipated. And the blanket exemption approach leaves regulators without the tools necessary to adequately protect customers.

The MCV is a good example. If it qualifies as a cogenerator it has a blanket exemption from the Holding Company Act. This is due to the exemption from the Holding Company Act for all cogenerators contained in a 1978 law, the Public Utility Regulatory Policies Act or PURPA.

But when it was passed PURPA was expected to mainly encourage scattered small projects such as windmills on top of houses, some small hydroelectric dams and electric generation at industries such as paper mills. It was totally beyond anyone's conception that it would be used a few years later for a project such as the MCV which is based on an abandoned nuclear plant, cost billions of dollars and was mainly developed by a utility. But this blanket exemption has significantly aided Consumers Power and the MCV in actions that will cost the customers of Consumers Power billions of dollars.

For that reason any exemption that Congress creates for EWG's from the Holding Company Act should be granted only on a case-by-case basis after notice and the opportunity for a hearing. This will help deter abuses that might otherwise occur, will result in

each project being reviewed on its own merits and will result in exemptions being carefully tailored and conditioned so that in each particular situation the public interest is served.

The case-by-case approach has worked smoothly in FERC's review of applications for PURPA projects and should be adopted for EWG's, given the billions of dollars that our experience has shown is at stake. Non-abusive projects will get their exemptions and abusive projects will not.

#### Transmission Access

The stated goals of the Holding Company Act amendments you have under consideration are to promote meaningful competition in electricity supply, to increase electricity supplies and as a result to help keep electric rates down. This will not occur unless all utilities have access to the electric transmission system on the same terms that utilities like Consumers Power and Detroit Edison provide themselves, each other and their affiliates. Without equal transmission access many utilities will be barred or artificially limited from obtaining the least cost electricity for their customers and electric rates will go up.

I'm going to mainly use Michigan examples in my testimony because I am familiar with its' situation and because many of the actions of Consumers Power are so blatant. However my testimony is supported by utilities in many states and by the trade associations for municipal and cooperative utilities serving 25% of the U.S. population specifically because similar situations and problems on transmission access occur nationwide.

As shown on the attached map, the two principal utilities in Michigan's lower peninsula are Detroit Edison and Consumers Power Company. Their general service areas are shown, within which they own most of the transmission lines. There are 45 other utilities in the lower peninsula, but to keep things simple I've only shown two or three, plus the MCV and a few hypothetical EWG's.

Equal Transmission Rights: Many of the larger privately-owned utilities in the country have reciprocal agreements between them that effectively give them extensive transmission rights over each other's lines. This is the case with Detroit Edison and Consumers Power, both as between them and in their agreements with comparable adjacent utilities in Canada, Indiana and Ohio. These transmission rights occur in bilateral and multilateral utility agreements as well as in regional agreements among the large utilities in a particular area of the country.

But the smaller utilities, who are usually the municipal and cooperative utilities, are largely excluded from these transmission arrangements, and are "landlocked" as a result. This is harmful enough in our day-to-day utility operations. But it is completely inconsistent with the kind of meaningful competition in electricity supply which the Holding Company Act amendments supposedly are intended to create.

For example, Detroit Edison and Consumers Power have reciprocal agreements with each other on using each other's transmission lines to the point that Consumers Power uses Detroit Edison lines to deliver electricity from the MCV to utilities in

Canada and has agreed with Detroit Edison to offer to let Edison own part of and use part of new transmission lines which Consumers builds. But our utilities are excluded from these agreements. And this exclusion is unnecessary, because in many areas of the country all utilities, including the smaller ones, can use the transmission system on equal terms for many types of transactions.

Michigan Example: As a result of the agreements between them, if Detroit Edison wanted to obtain electricity from an EWG or cogenerator located in Consumers Power's service territory it presumably could do so at very low cost, and vice versa. But these rights do not extend to our utilities. So if the City of Holland's municipal utility wanted to obtain electricity from an EWG located in Consumers Power or Detroit Edison territory, it might not be able to do so at all, and it certainly would not be able to do so on as favorable terms as the two large utilities provide each other.

This is because if an EWG in the Edison service area is offering to sell at the lowest price around, the Holland municipal utility and approximately 35 other outstate utilities may have no reasonable way to get Detroit Edison to transmit the electricity for them. This is because Detroit Edison currently has no transmission rate available for other utilities generally even though Edison will transmit electricity for Consumers Power Company. And because Holland would still need to use Consumers Power's transmission lines to get the electricity from the Edison boundary to it, there is a big risk that Consumers Power would try

to increase its transmission charges enough to make a higher-priced purchase from it or from its "deregulated" affiliates more economic than Holland's purchasing from the low-cost EWG. The example I've just given doesn't just affect Michigan utilities--it would prevent many utilities in Indiana and Ohio from purchasing from this favorably priced EWG as well. They too will have to get more expensive electricity someplace else.

This example shows how if some utilities have more equal access to transmission lines than others, the disfavored ones operate under a severe handicap as they try to operate and obtain low-cost electric supplies from other utilities, cogenerators, EWG's or even from their own plants that are located some distance away. And the EWG's lose the market for their electricity unless the utility where the EWG is located will buy it.

More generally, S. 1220 as it stands now allows utilities to own EWG's. Without provisions in the bill for adequate transmission access what S. 1220 does is allow the dominant utility in an area which owns most of the transmission lines to discriminate in the terms on which it makes transmission service available in favor of its affiliate. As I just described result the "landlocked" small utilities in its service area will effectively be forced to buy high-priced electricity from the dominant utility's affiliate. This will prevent lower-cost truly independent EWG's from selling to the landlocked utilities and will force the EWG's out of business.

And due to comparable restrictions that will likely be created

by other nearby large transmission-owning utilities, low-cost independent EWG's elsewhere will be discriminated against or unable to sell power to our dominant utility. The result is that high-cost utility-affiliated EWG's are deregulated. They do not face real competition from lower-cost truly independent EWG's and electric rates go up unnecessarily for our utilities' customers and for most utility customers.

**Florida:** Another significant example of the importance of all utilities' having equal access to transmission comes from Florida. Florida Power & Light Company owns most of the transmission on the Atlantic ocean side of Florida. As a result, it can sell electricity from its own generators, which are located throughout much of Florida, as well as from generating plants of other utilities. On behalf of its municipal members, the Florida Municipal Power Agency wants to operate city-owned generation and to use electricity purchased from other sources. The Agency wants to be able to compete for the lowest cost generation in the same way as Florida Power & Light does.

It cannot do so because Florida Power & Light wants to impose on Florida Municipal Power Agency multiple, duplicative transmission charges by charging the agency separately for each, individual point-to-point transmission "path" to get electricity to where it is used. By contrast, Florida Power & Light itself uses transmission lines on a network basis where it pays once and can then move electricity anywhere on the transmission system. Through its control of the transmission system, Florida Power &



Light is thus preventing the Florida Municipal Power Agency from having the same operating opportunities that Florida Power & Light has, thereby advantaging itself in competing for electricity supplies from EWG's or other sources and creating higher electricity rates for the Agency and its member cities.

Pennsylvania: A related example comes from Pennsylvania. General Public Utilities ("GPU") wants to construct new high voltage transmission lines to get inexpensive power from the Duquesne Light Company, the electric utility which serves the Pittsburgh area. GPU will not allow the Allegheny Electric Cooperative, which serves electricity to its members throughout Pennsylvania, to help plan these new transmission lines so as to best serve both utilities' customers or to own a portion of the new facilities, even though Allegheny is willing to pay to do so.

GPU is thereby blocking Allegheny, a cooperatively owned utility, from getting electricity from inexpensive sources in neighboring regions. This monopoly control of transmission hurts both potential sellers and Allegheny's member-consumers, to the economic advantage of GPU.

Phony Transmission: The same result as denying transmission access occurs if a utility nominally makes transmission service available, but only on very limited terms. As an example, people who build generating plants need long-term commitments to purchase the power before the plant can be built. Otherwise the lenders won't provide the money to build it. For example, an EWG will typically have a 15 to 25 year mortgage. Therefore, the EWG and

its lender will want a power sales contract with us for at least that many years so they can be assured the funds will be coming in to pay off the mortgage. Let's again assume that Holland, one of our utilities located in the Consumers Power service area, wants to buy from an EWG located about 50 miles away. Consumers Power does have a transmission rate available to all utilities. But the good news stops there: It's a weekly rate, Consumers Power reserves the right to try to change the rate at any time, and right now it is mentioning some very large increases.

The EWG and its lenders will squarely shift the transmission problem to us, saying "Holland, you buy and pay for the power at the EWG plant gate and it's your expense and risk as to whether you can get it transmitted to your utility or what the transmission price will be for 25 years."

How can Holland or any of our utilities enter into a 25-year contract to buy electricity from an EWG when Consumers Power only makes transmission access available a week at time? And when Consumers Power can try to change the rate for transmission or the terms at any time? And when in general we have to pay the changed transmission rate Consumers Power has proposed and abide by any changed terms for the years it may take the FERC and the courts to rule on whether the changes are legal?

There are some risks we'll take as municipalities or cooperative utilities, but transmission limitations can be devastating with tens or hundreds of millions of dollars of payments to be made even if we can't get the electricity to our

utilities. We need assurances that the transmission will be available and that the rates and terms for it will be fair so that we don't find out years into the transaction that the rate is prohibitive or the terms such as to make it useless. These are reasonable requests by responsible municipal officials, co-op managers, mayors, councils, voters and the like before we make major financial commitments.

This example of "phony transmission" being made available by Consumers Power Company is not unique. The same example could be used with other utilities. But it clearly shows how there's less there than meets the eye if a utility says that it does provide transmission access for other utilities and how such phony transmission will prevent the kind of competition that Title XV is supposed to promote.

Transmission Self-Dealing: Finally I simply want to point out that in contrast to the way Consumers Power treats our utilities, it goes to great lengths to provide transmission access for its affiliates.

Look at what's happened recently:

- The MCV wanted to sell large amounts of electricity to Canada. It would have had to move first over Consumers Power's lines, then over Detroit Edison's and then into Ontario, but Detroit Edison refused to transmit electricity when the MCV requested it, apparently in part because it was not a utility. So Consumers Power turned around and bought the electricity from the MCV,

immediately resold it to Canada, and forced Detroit Edison to transmit it as "Consumers Power electricity" under the reciprocal transmission agreements between the utilities.

- CMS Energy and the MCV have spoken widely--to Wall Street and to utilities--about selling electricity from the MCV (or from a huge new expansion planned for it) to utilities throughout the Midwest. That electricity first has to move over Consumers Power's lines to get there. For anyone else that would be a major problem--for MCV it apparently is not because CMS controls both the MCV and Consumers Power and both will dance to the CMS tune.
- Consumers Power is trying to build a new 110-mile transmission line to Indiana. As utilities we are very skeptical whether that line is needed. It appeared during a Congressional Hearing last month that the main reason the line was being built was to transmit electricity out of state for the MCV. But Consumers Power has refused to submit the line to our state Public Service Commission for a determination of whether it's really necessary or not.
- Consumers Power often refuses to talk with truly independent cogenerators or power producers about transmitting electricity for them until they have a signed agreement with a utility to purchase the power. This puts the true independents and their would-be

utility purchasers in an impossible chicken and egg situation. Yet some of the documents that have turned up in lawsuits show that Consumers will talk with its MCV and Palisades affiliates about transmission at any time, will give them cost estimates to build lines and will enter into long-term agreements with them about providing transmission access.

**Transmission and Competition:** As all my examples illustrate, if some dominant utilities can use their control of transmission networks to block generation, then passage of the proposed Holding Company Act amendments will deny the public the benefits of competition and will increase electric rates. The worst of all possible worlds would be deregulation without competition where some utilities can favor above-cost purchases from their affiliates and block competitors from buying from less expensive resources.

The key is this: Transmission lines are the highways of commerce in the electric area. They are essential for utilities to obtain and efficiently use their power supplies. They form regional transmission networks that have been planned and built by some of the larger utilities in the region. Transmission lines generally are monopolies.

But they have been developed by utilities' extensive use of such governmental powers as franchises and the power of condemnation. They are often built only after a regulator determines that they are necessary for the public as a whole. They are paid for by the public through rates. Utilities have public

obligations not to use monopoly control of essential facilities they own such as transmission lines in ways that are injurious to other utilities or the public: The lines are used by public utilities and should be used for the benefit of the entire public, not just a portion of it. The lines are thus a public trust and the utilities who own them should not be able to allow their use by some utilities but exclude use by other utilities for the owner's private advantage.

Competition can help assure adequate electric supplies and limit price increases. But it will not work unless all public utilities have the same right to own and use the transmission lines and public rights of way. Title XV of S. 1220 will not promote meaningful competition if certain favored utilities can artificially prevent or restrict competition by other utilities.

So you will not get a competitive result from S. 1220 when many of our utilities--who serve about 25% of the U.S. population--aren't allowed to compete at all or can only do so on highly disadvantageous terms.

Transmission--Remedy: There's a fairly easy answer to the transmission problem. The electric transmission system is made up of regional utility grids with the lines in each region being built and owned by several different utilities. These dominant utilities work together to carefully plan and jointly use these lines to meet their joint needs. An example is Consumers Power agreeing to let Detroit Edison own part of new Consumers Power transmission lines.

Currently, these larger utilities typically exclude the

smaller landlocked utilities from participating in regional transmission line planning, ownership and use in ways that work to the larger utilities' private advantage. The answer is to expand the current multiple ownership of the regional transmission system by allowing all utilities to participate on equal terms. This is occurring in Michigan to a limited degree already--as the result of line construction, past antitrust cases and power plant purchases our municipal and cooperative utilities currently own a small portion of the transmission lines in Michigan. In general this gives our utilities the right to move electricity anywhere on the transmission system or from specific plants, but only up to the amount of transmission capacity we own, which is currently inadequate.

In Michigan, we have proposed that the arrangements be extended to give all our utilities the option to build new parts of the transmission system in proportion to their usage of it, and with corresponding obligations for costs of maintaining the system. We have shown how this would be the least-cost solution for Consumers Power and its customers, for us and for the citizens of Michigan as a whole.

Due to their obvious benefits, similar arrangements currently exist in portions of New England, Indiana, Texas, Georgia, Wisconsin and several other states. For the same reasons, at the national level various groups are currently discussing or proposing joint ownership or joint participation plans for transmission lines.

Joint ownership or joint participation isn't the only way to assure that transmission lines are used in a way that is most in the public interest. Other ways can work if they lead to all utilities' having access to the transmission system on the equal terms.

In addition, my lawyers tell me that the Federal Energy Regulatory Commission has the authority to order utilities to transmit power, such as to avoid discrimination or remedy anticompetitive conduct. However, they also tell me that the Federal Energy Regulatory Commission and many utilities have often taken the position that the Commission has limited authority to order unwilling utilities to transmit. Under the circumstances, Congress should clarify that the Commission may order the major privately-owned utilities that control the transmission grids to provide municipally and cooperatively owned utilities transmission services over the transmission networks on non-discriminatory rates, terms and conditions. This will give the smaller utilities transmission on a basis which is economically and functionally equivalent to the use of the transmission systems available to the large privately-owned utilities and their affiliates.

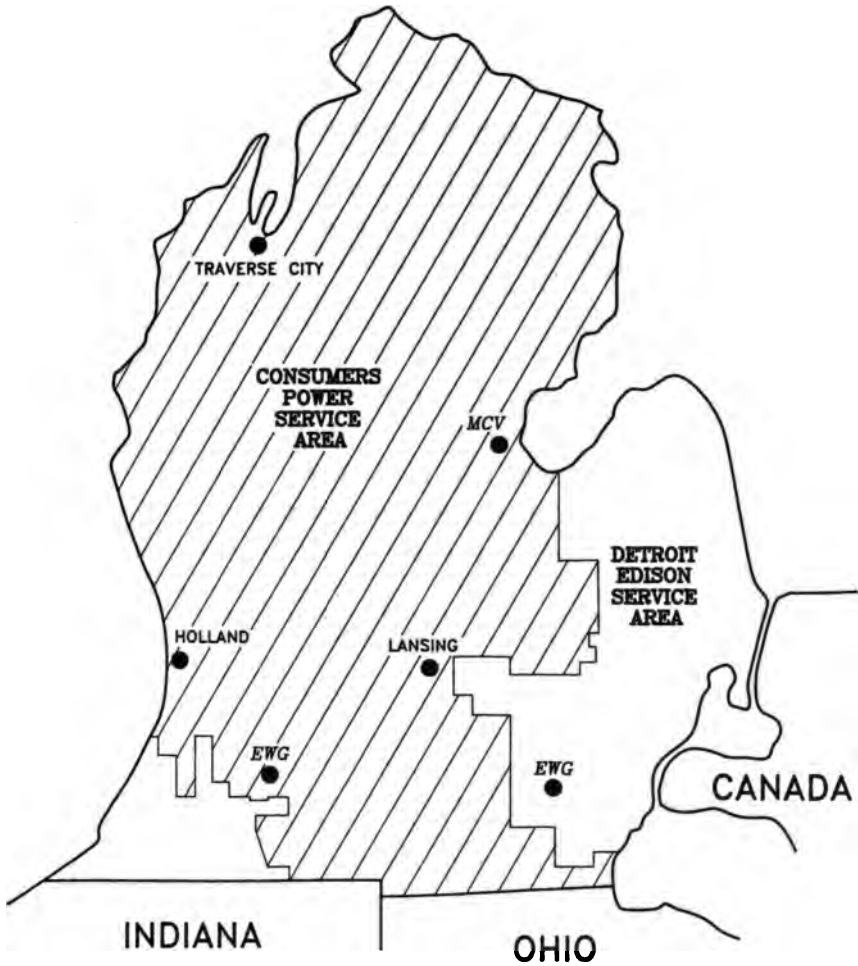
Conclusion: The key to the so-called Holding Company Act reforms before you is equal transmission access. With it you increase competition in the electric generation business and help keep electric rates low. Without it you simply create a class of would-be sellers and eliminate existing statutory safeguards, but do not address the artificial barriers that keep EWG's and



utilities from being able to do business. You may have a few more competitors but by opening the door to sweetheart deals among utilities and their affiliates, you may actually reduce competition. And if you then let this "market" set the price for new electricity supplies, which is the direction some are headed in, the prices will be too high and electric rates will be too high.

Thank you for allowing me to testify today. I would be pleased to answer any questions you may have.

## MICHIGAN LOWER PENINSULA SERVICE AREAS



• MAP SHOWS ONLY 5 OF 47 LOWER PENINSULA ELECTRIC UTILITIES

UNITED STATES HOUSE OF REPRESENTATIVES  
Committee on Energy and Commerce  
SUBCOMMITTEE ON ENERGY AND POWER

TESTIMONY  
OF THE

MICHIGAN PUBLIC SERVICE COMMISSION

STEVEN M. FETTER, Chairman

William E. Long, Commissioner  
Ronald E. Russell, Commissioner

on

H.R. 1301, Title IV, Subtitle A

and

H.R. 1543, Title IV, Subtitle A

PUBLIC UTILITY HOLDING COMPANY ACT REFORM

May 2, 1991

UNITED STATES HOUSE OF REPRESENTATIVES  
 COMMITTEE ON ENERGY AND COMMERCE  
 SUBCOMMITTEE ON ENERGY AND POWER

Responses of the Michigan Public Service Commission  
 to Prehearing Questions

- Q1.** I understand that your Commission has been very involved in issues of self-dealing and cross-subsidization. Please comment.
- A1.** Michigan's experiences demonstrate the problems that can arise as a result of PUHCA exemptions currently available and the potential for putting electricity consumers at risk if protections are not built into any PUHCA reform. During the last several years, we have gained significant experience with a utility and its affiliates that have been exempted from many provisions of the Holding Company Act.

Under Section 201 of PURPA and related regulations, public utilities or public utility holding companies may own up to a 50 percent equity interest in a qualifying facility (QF). See 16 U.S.C. § 796 (18)(B)(ii) and 18 C.F.R. 292.206. QFs are exempt from certain provisions of the Federal Power Act (FPA), PUHCA, and state utility law. 18 C.F.R. 292.601, 292.602.

Presently more than 95 percent of QF capacity in Michigan is owned by utility affiliates. Because the bills before the Committee would provide similar benefits for EWGs, Michigan's experience in regulating transactions between utilities and affiliated QFs is directly relevant.

Several cases before the MPSC have demonstrated that self-dealing, cross-subsidization, and other anti-competitive behavior can be a major concern when utilities are allowed to purchase power from less closely regulated affiliates. The majority of these cases relate to a utility holding company, CMS Energy Corporation (CMS), its utility subsidiary, Consumers Power Company (Consumers), and its numerous other affiliates, including a QF, the Midland Cogeneration Venture (MCV).<sup>2</sup>

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<sup>2</sup> CMS Energy Corporation is a utility holding company with approximately 60 subsidiaries and affiliates. The largest of these is Consumers Power Company, which is a combination electric and gas utility with approximate annual operating revenues of \$1.85 billion from 1.46 million electric customers and \$1.05 billion from 1.35 million gas customers (1990 Annual Report). Since CMS Energy describes itself as "a \$3 billion (sales) diversified energy holding company" it is clear that a substantial portion of the holding company's revenues flows from the regulated utility.

In order to help the Members visualize the structure of the holding company being discussed, we have included as Appendix A, an organization chart of CMS Energy Corporation as reported in its 1990 Annual Reports to the Michigan Department of Commerce, Corporations and Securities Bureau. In addition, Appendix B identifies those directors and officers of CMS Energy, its affiliates and subsidiaries, who have responsibilities related to two or more CMS affiliates.

In Appendix C, we have attached a series of excerpts from Commission orders related to CMS Energy Consumers Power Company and other affiliates. The activities of CMS Energy are highlighted here because, by its own actions CMS Energy has singled itself out as by far the most aggressive utility holding company in Michigan with respect to testing the limits of applicable laws--both state and federal. The volume, complexity and expense of litigation related to CMS Energy's activities is unprecedented. A disproportionate amount of Commission staff, Attorney General, and other intervenor resources have been, and continue to be, expended on efforts to provide proper oversight and prevent unnecessary rates and risk from being assigned to Consumers Power Company by CMS Energy.

In contrast, we have little to report on affiliate abuses from other electric utility holding companies in Michigan<sup>3</sup> because complaints with respect to those other companies have not been filed.<sup>4</sup>

CMS Energy has an intrastate exemption from the Holding Company Act. This exemption, in combination with the exemption for qualifying facilities under PURPA, has led to a proliferation of attempt to maximize shareholder profits at potential expense to ratepayers of Consumers Power Company. With these exemptions, corporate structure and transactions between corporate affiliates have been manipulated to attempt to ensure

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<sup>3</sup> Other electric utility holding companies in Michigan include:

Registered Holding Company--American Electric Power Company

Subsidiaries: Indiana Michigan Power Company and Michigan Power Company.

Exempt Holding Companies--Subsidiaries

Cliffs Electric Service Company--Upper Peninsula Generating Company

ESELCO, Inc.--Edison Sault Electric Company

Upper Peninsula Energy Corporation--Upper Peninsula Power Company

Wisconsin Energy Corporation--Wisconsin Electric Power Company

WPL Holdings, Inc.--Wisconsin Power & Light Company

<sup>4</sup> We note that, in addition to differences in reported abuses, there are differences in company positions regarding PUHCA reform. The two largest electric utilities in the state (Consumers Power Company and Detroit Edison Company) have diametrically opposed positions on the issue.

that all the advantages of competition--without the risks--reside with the holding company or its affiliates which are not subject to rate regulation. That is not competition.

As is detailed in the appended excerpts from several recent MPSC orders (Appendix C), the documented behavior has included:

- Drawing resources away from the utility to benefit affiliates;
- Lack of arm's length bargaining;
- Self-dealing resulting in favoritism to affiliates;
- Oversubscription of generating capacity resulting in inefficiencies;
- Utility assuming risk on behalf of affiliates;
- Misuse of ratepayer funds to benefit affiliates;
- Restructuring the corporation in ways that are harmful to the regulated utility; and
- Using the holding company structure to impede appropriate reviews by the state regulatory commission by:
  - Substantially increasing the complexity of cases;
  - Denying access to books and records of affiliates that have engaged in transactions with the utility;
  - Refusing to comply with lawful orders of the Commission; and
  - Engaging in a myriad of legal maneuvers in the courts.

The abuses listed above are of the same type as those which led Congress to pass PUHCA in 1935. (See generally 15 U.S.C. § 79a(b) PUHCA 1(b); see also *The Public Utility Holding Company Problem*, 25 Cal. L. Rev. 517 (1937).) Because of the danger of affiliate abuses, and its concomitant effect on captive ratepayers, it would be a serious mistake to weaken consumer protections related to power purchase agreements between utilities and affiliated non-utility generators.

To avoid this, Michigan would recommend giving state public utility commissions jurisdiction over the provisions in contracts between a non-utility generator (whether QF or EWG) and an affiliated utility if both are located in the same state.

Specifically, we would propose adding a new subsection to Section 404 of H.R. 1301, as follows:

Notwithstanding Section 201(b) of the Federal Power Act, the justness and reasonableness of a power purchase contract between a utility and an affiliated exempt wholesale generator or qualifying facility physically located in the same state, (1) shall be subject to the jurisdiction of the state public utility commission and shall not be subject to the jurisdiction of FERC.

Another approach would be to amend PUHCA to prohibit transactions between non-utility generators and affiliated utilities unless expressly allowed by the affected state. To do this, a new subsection could be added to Section 404 of H.R. 1301 as follows:

Notwithstanding any provision of the Act, no power purchase contract between a utility and an affiliated exempt wholesale generator or qualifying facility physically located in the same state shall become effective unless its provisions are approved by the state public utility commission.

As a third alternative, utility ownership of EWGs could be prohibited by adding the following proviso to the definition of "exempt wholesale generator" in Section 401 of H.R. 1301:

But "exempt wholesale generator" shall not include any company, 10 percent or more of which company's voting, non-voting or ownership securities are directly or indirectly owned by an electric utility company to which that company is selling electric energy, or by an affiliate of such an electric utility company.

Michigan is also concerned that a contract between a utility and an EWG affiliated with another utility might be susceptible to abuses, such as the arranging of mutually noncompetitive purchases. Michigan proposes providing regulatory oversight of such transactions to the state in which the purchasing utility is located.

For EWGs that are not affiliated with a utility, Michigan believes that PUHCA should not apply. In fact, Michigan would go so far as to suggest that, except for prudence review, pricing regulation may not be necessary for such transactions. Arm's length bargaining would substitute for regulation. The regulatory scheme proposed here would accordingly encourage a truly independent generation sector and would offer more protection against affiliate abuses than does H.R. 1301 and H.R. 1543.

**Q2. As a matter of energy policy, do you believe the federal government should encourage the growth of independent power?**

**A2. Yes.** The key word is "independent". Independent power producers should be encouraged by removing barriers to competition, whether those barriers are contained in law or imposed by entities with strong market power. Encouragement of independent producers should not extend, however, to include subsidies of their activities by utility ratepayers or taxpayers.

Although Michigan is concerned about the unpredictable effects of a major restructuring of the electric utility industry, it believes that the potential benefits outweigh the risks so long as independent EWG-utility transactions will actually be subject to market discipline and transactions between utilities and affiliated generators can be carefully scrutinized.

**Q3. Do you believe greater reliance on independent power carries risks for utilities and ratepayers? Specifically:**

**(a). Is there anything inherently less reliable about power purchased under contract than power generated by the utility with the obligation to serve? Can contracts be crafted to protect utilities and ratepayers from the failure of an independent power project?**

**A3(a).** There is no inherent reason why a utility with the obligation to serve cannot structure its power supply portfolio to include significant quantities of power purchased from independent generators under long term contracts. A major tool that a utility can use to mitigate risk to its ratepayers and shareholders is to maintain a diverse mix of supply sources. This diversity, in combination with other factors such as tightly structured contracts and a close matching of demand to supply, should allow a utility to continue to offer reliable service to all those who request service in its franchise area.

The utility will, ultimately, still be responsible for ensuring the reliability of its service.

**(b). It is widely assumed that independent power projects will be financed by a higher percentage of debt than utility-built capacity. Is there anything inherently risky, from the ratepayer or shareholder's point of view, about depending on highly leveraged projects?**

**A3(b).** It should be assumed that a prudent utility would weigh the risks of an EWG resulting from its leveraging when considering long-term purchase contracts with that EWG.

The major risk to ratepayers and shareholders from highly leveraged non-utility generating projects comes when the utility's assets are used to guarantee or secure the debt in some fashion, whether directly or



indirectly.<sup>5</sup> This situation is most likely to occur when a non-utility generator is affiliated with the purchasing utility.

Regardless of whether a utility-affiliated generator is selling power to its sister utility or someone else, undue risk is attached to any utility whose assets are being used to finance a highly-leveraged project. On the other hand, if assets from investors totally unrelated to a utility are used to acquire financing for a non-utility generator, a utility's ratepayers and shareholders can, assuming prudently crafted contracts, potentially be better protected from the risks of a failed generating plant than they would be if the utility attempted to build its own plant and failed.

**Q4.** Skeptics of PUHCA reform argue that states vary widely in their ability to address potential problems involving cross-subsidization and affiliate transactions. Do you agree? If so, should PUHCA legislation try to redress such disparities?

**A4.** Yes. We would argue that the Congress must act to ensure protection for all ratepayers and true competitors from inappropriate uses of a utility holding company structure by providing regulators, especially state regulators, with the tools necessary to protect the public interest.

Michigan is concerned that if utilities are freely allowed to enter into power purchase agreements with affiliated generators, the states may lack the regulatory resources<sup>6</sup> to prevent self-dealing, cross-subsidization, and other anticompetitive actions. This concern about the difficulty of ferreting out and preventing such abuses was an impetus behind PUHCA. (See 25 Calif. L. Rev. at 531-42.)

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<sup>5</sup> Over-leveraging within a holding company system was one of the evils that led to the passage of PUHCA in 1935. As William Weeden of the SEC Staff recently explained:

[e]ffective control of extensive utility systems could be acquired with minimal equity investments by small groups of investors who exploited the subsidiary operating companies for their own gain at the expense of other investors and consumers.

PUHCA in Past Context: Independent Power Meets the "Mystic Maze," Electricity Journal 24, 25 (January/February 1990). As the experience of the last decade demonstrates, the dangers of over-leveraging have not diminished since the 1930s.

<sup>6</sup> In its analysis of the costs and benefits of its proposal, the Administration estimated that the FERC and the states together would need up to 250 additional staff people to protect the public from potential abuses in a deregulated generating sector. Based on Michigan experiences to date, this estimate is probably conservative.



data from 1990 Michigan Department of Commerce, Corporations & Securities Bureau Annual Reports

U = Deutsch  
O = Öfter  
U = Ueber

UNITED STATES HOUSE OF REPRESENTATIVES  
Committee on Energy and Commerce  
SUBCOMMITTEE ON ENERGY AND POWER  
TESTIMONY OF THE NUCLEAR PUBLIC SERVICE COMMISSION  
on H.R. 1361 and H.R. 1543

**April 25, 1991**

UNITED STATES HOUSE OF REPRESENTATIVES  
Committee On Energy And Commerce  
SUBCOMMITTEE ON ENERGY AND POWER  
Testimony of the  
MICHIGAN PUBLIC SERVICE COMMISSION  
on  
H.R. 1301, Title IV, Subtitle A  
and  
H.R. 1543, Title IV, Subtitle A  
PUBLIC UTILITY HOLDING COMPANY ACT REFORM

APPENDIX C

Excerpts From Commission Orders Containing Examples of Findings  
of Affiliate Abuses

Captions are provided to enhance the reader's understanding. They are not part of any of the referenced documents.

**\*\* DRAWING RESOURCES AWAY FROM UTILITY TO BENEFIT AFFILIATE \*\***

"...following the financial stabilization orders in 1985, Consumers has effected a sweeping reorganization of its corporate structure, creating CMS Energy as its parent company, CMS Enterprises as a subsidiary of CMS Energy and sister to Consumers, and several new subsidiaries, including Midland Group Limited and MEC Development Company. Further, the MCV was also formed, and Consumers unilaterally assigned Midland plant assets at a booked value of approximately \$1.5 billion to the MCV for purposes of developing a gas cogeneration plant at Midland, in conjunction with Dow Chemical and other partners. In more recent months, Consumers or its parent company, CMS Energy, has also undertaken a series of financial transactions aimed at transferring the booked Midland plant assets of Consumers (along with other financial and corporate assistance from Consumers) to the MCV while at the same time ensuring that proceeds of those Midland plant assets would flow back, not to Consumers but to its claimed unregulated parent company, CMS Energy. On the eve of expected Commission or court action relating to the Midland plant proceeds, CMS Energy purchased from Midland Group Limited, a wholly-owned subsidiary of Consumers, all of the capital stock of CMS Midland and MEC Development, in return for Midland Group Limited's receipt of a debenture of CMS Energy in the principal amount of \$1.4 billion. Only after completion of this transaction did the MCV transfer \$500 million of marketable notes to MEC Development which also possesses the right to receive an additional \$700 million of notes from the MCV. One potent result of these recent transactions is to deprive Consumers of any of the cash flow or other financial benefit from the transfer of Midland plant assets previously owned by Consumers to the MCV, which is inconsistent with our previous orders in Case No. U-7830 Step 3A providing financial stabilization relief designed to improve Consumers' cash flow."

U-7830 Step 3A et al., 3/27/90, p. 8-9.

**\*\* LACK OF ARM'S LENGTH BARGAINING \*\***

"Consumers and the MCV would have this Commission believe that their power purchase agreement must be fair and reasonable because it resulted from "arm's-length" negotiations between the parties. However, the record does not support this conclusion. Rather, the record establishes that the Consumers/MCV contract did not result from arm's length negotiations...."

"Mr. Giffels described himself as MCV's chief negotiator.... While Mr. Giffels conducted "arm's length" negotiations on behalf of the MCV, he was reporting to Consumers vice-president Cook....Mr. Giffels admitted that he drew his paychecks from Consumers for the first six to nine months of the bargaining period. The record shows that most, if not all of the persons assisting Mr. Giffels in conducting his negotiations on behalf of the MCV were also being paid by Consumers ...Other MCV officials also had important continuing ties to Consumers ...the testimony reveals that Consumers had a dominant, controlling role in the MCV at the time of contract negotiations....The Commission observes that, unlike most arm's-length transactions, Consumers and the MCV share a commonality of interest. Specifically, both Consumers' shareholders and the MCV partners benefit from higher capacity rates and lenient contract provisions."

U-8871 et al., 1/31/89, p. 98-102.

"It is ...clear that the various transactions between Consumers and its parent company, CMS Energy, and their affiliates were not effected through arm's-length bargaining. All of these corporations are headed by the same individuals and by essentially the same senior staff. The blurring of corporate identities is illustrated by Mr. McCormick's response when asked if he is the chief executive officer of CMS Midland: "I'm not sure of that. I'm not denying it but I'm really not sure." (Tr. 278.)

U-7830 Step 3A and U-9611, 5/23/90, p. 32.

**\*\* SELF-DEALING RESULTING IN FAVORITISM TO AFFILIATE \*\***

"It is apparent that the company's overwhelming corporate objective is to obtain Commission approval for as much as possible of the MCV capacity now and first priority for an additional 250 MW of MCV capacity when more capacity is needed, regardless of the interests of its ratepayers and the policies embodied in PURPA....One can only speculate whether the company would be as eager to put itself "at risk" for the additional 250 MW of MCV capacity if it did not own a substantial interest in the MCV....This Commission ...must...consider our responsibility to balance all interests, including those of the company's ratepayers.

In balancing those interests, the Commission flatly rejects any suggestion that the public interest and PURPA are well-served by a corporate policy that pursues maximum MCV capacity as its highest priority...."

U-8871 et al., Opinion and Order, 6/22/89, p. 20-21.

**\*\* OVERSUBSCRIPTION OF GENERATING CAPACITY RESULTING IN INEFFICIENCIES \*\***

"....the company's proposed approach for additional MCV capacity provides significant opportunities for the company to affect the need for that capacity in ways that are not conducive to a rational energy policy for the state. If the company were so inclined, it could retire or derate capacity that it would not otherwise retire or derate; it could refuse to enter into new firm contracts for long-term capacity; it could enforce its contracts with qualifying facilities in ways designed to prevent or discourage the commercial operation; it could engage in marketing activities designed to increase summer peak demand; it could refuse to promote conservation and load management; and it could refuse to exercise its rights under its interruptible rates. In short, the company's proposal is not without significant risks that ratepayers will pay for the 250 MW of additional MCV capacity, regardless of whether there are reasonable opportunities to avoid the need for that capacity. Consumers' activities to date with regard to the MCV provide no basis to believe that the company will not seek additional ways to promote the interests of the MCV, and thereby Consumers' stockholders, at the expense of its ratepayers."

U-8871 et al., 6/22/89, p. 37-38.

**\*\* UTILITY ASSUMING RISK ON BEHALF OF AFFILIATE \*\***

"A final concern related to the 352 MW of capacity, as well as the 250 MW of capacity, is Consumers' claim that its ratepayers are not at risk with respect to that capacity. The company acknowledges in its ancillary filing that if it is unable to find a market for both blocks of power, its potential financial exposure to the MCV is approximately \$180 million per year. As pointed out by ABATE and the Attorney General, that a significant sum of money for any utility, especially one that continues to obtain financial stabilization rate relief from its customers. It is therefore disingenuous for the company to claim that its customers are not at risk under a contract that requires Consumers to pay for electricity from the MCV whether there is a market for it or not."

U-8871 et al., 6/22/89, p. 40-41.

"...The utility...signed ten direct purchase contracts under which it planned to buy gas during 1989...the record reflects that Consumers had also been authorized to negotiate gas purchase contracts on behalf of the Midland Cogeneration Venture Limited Partnership (MCV), and had succeeded in obtaining contracts on behalf of the MCV with these same ten producers...."

....First, the Commission finds that the contracts signed by Consumers and the MCV with each of these ten producers were negotiated as a package deal....Second, the record indicates that certain beneficial aspects of the MCV's gas purchase contracts were likely obtained at the expense of Consumers' sales customers. For example, a review of the MCV's supply contracts shows that...they did not require the MCV to purchase any minimum volumes of gas during 1988 and 1989. In contrast, Consumers' contracts with these same producers obligated the utility to begin purchasing gas immediately. This is despite the fact that, according to the utility's assessment...taking gas from these ten producers would leave Consumers significantly over-contracted until at least 1990....We therefore find that the utility's expected cost of gas from new direct supplies should be reduced by one-half of the projected cost differential, or \$3,730,000."

U-9173, Opinion and Order, 5/3/90, p. 22-27.

**\*\* RESTRUCTURING HARMFUL TO REGULATED COMPANY \*\***

"....In the spirit of the extraordinary rate increase, the Commission expected that Consumers would use a of its management skills, self-help and financial and business opportunities to strengthen its utility operations and financial position, and Consumers' management provided an unqualified commitment to comply with the latter and the spirit of the conditions attached to the extraordinary Step 3A rate relief. [Consumers' electric rates are still not based on the cost of service and will not be until its pending rate case, Case No. U-9346 is concluded.]

"The testimony of Consumers' and CMS Energy's officers and the proposal offered by Mr. Fryling during rebuttal illustrate how far the current management of the company has moved from the spirit of Step 3A. Instead of using its resources to return the company to financial health, the company's management has pursued all conceivable legal and regulatory avenues to separate the benefits of improved financial health from the utility and to transfer them to the parent holding company, where they can be used in whatever way those managers see fit, even though Consumers has not yet achieved financial health and faces many near-term uncertainties that prudent managers would not ignore. What has developed is a concerted effort to prevent the utility from obtaining cash to meet its obligation and prepare for contingencies and, instead, to use the cash from Midland plant assets for non-utility enterprises. The Commission would not be carrying out its appropriate regulatory responsibilities if it quietly acquiesces to this course of action."

U-7830 Step 3A and U-9611, 5/23/90, p. 41-42.

"....Among other things....Consumers transferred the usable assets but did not transfer the liabilities, which still remain on Consumers' books."

U-7830 Step 3A and U-9611, 5/23/90, p. 33.

**\*\* MISUSE OF RATEPAYER FUNDS \*\***

"Also on March 12, 1990, unbeknownst to the Commission, CMS Energy and its various affiliates, including Consumers and its subsidiaries, engaged in financial transactions that would transfer to CMS Energy (and its affiliates), rather than to Consumers, the proceeds related to the transfer of Consumers' \$1.5 billion in Midland plant assets to the MCV."

U-7830 Step 3A and U-9611, Opinion and Order, May 23, 1990, p. 9.

**\*\* EXTENT OF HEARINGS AND AMOUNT OF RESOURCES \*\***

"The hearings and prehearing conferences required 90 days. More than 60 parties participated and more than 100 witnesses testified. The record consists of 120 volumes of transcript, 14,383 pages, and 428 exhibits...."

U-8871 et al., Opinion and Interim Order, 1/31/89, p. 9.

"The Commission's March 27, 1990 order commencing the comprehensive review proceedings is presently the subject of petitions for review filed in CMS Energy v MPSC, Ingham Circuit Court Docket No. 90-65964-AA; Consumers Power v MPSC, Ingham Circuit Court Docket No. 90-65963-AA; and MCV v MPSC, Ingham Circuit Court Docket No. 90-65959-AA."

U-7830 Step 3A and U-9611, Opinion and Order, May 23, 1990, p. 9-12.

**\*\* IMPEDING COMMISSION REVIEW \*\***

"The contested case process...exists to protect the rights of litigants in administrative proceedings. However, [it] was never intended to allow a regulated utility to escape regulation through regulatory delay. It is abundantly clear to the Commission from a review of the record in Case No. U-9322 and the legal maneuvering in the courts of this state that Consumers and CMS Energy, have, on one hand, utilized all appropriate and some inappropriate means to delay our review and determination of its compliance with the financial stabilization conditions and the letter and spirit of our decisions in Case No. U-7830 Step 3A, while at the same time they were racing ahead with efforts to circumvent the Commission's ability to thoroughly review and remedy any potential violations of the financial stabilization conditions."

U-7830 Step 3A et al., 3/27/90, p. 15.



CONNECTICUT  
MUNICIPAL ELECTRIC  
ENERGY COOPERATIVE

**CMEEC**

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September 16, 1991

The Honorable Christopher J. Dodd  
Chairman, Securities Subcommittee  
United States Senate  
Committee on Banking, Housing, and  
Urban Affairs  
Washington, D.C. 20510-6075

Dear Senator Dodd:

Please find enclosed the summary and full statements of the Northeast Public Power Association (NEPPA) and the Connecticut Municipal Electric Energy Cooperative (CMEEC) regarding proposals for modifying the Public Utility Holding Act as proposed in Title XV of S. 1220, the National Energy Security Act of 1991. The requisite number of copies are enclosed.

These statements of NEPPA and CMEEC will be supported by Gabriel B. Stern of CMEEC in testimony before the Subcommittee on Tuesday, September 17, 1991. We again express our thanks to you for the opportunity to testify in this important debate.

Very truly yours,

CONNECTICUT MUNICIPAL ELECTRIC  
ENERGY COOPERATIVE

*Maurice R. Scully*  
Maurice R. Scully  
Executive Director

Enclosures: Summary Statement and Testimony

Serving Public Power in Connecticut

City of Groton  
Department of Utilities

City of Norwich  
Department of Public Utilities

Jewett City  
Electric Light Plant

Norwalk Third Trading District  
Electrical Department

South Norwalk  
Electric Works

**SUMMARY STATEMENT**

**Gabriel B. Stern**  
**Connecticut Municipal Electric Energy Cooperative**  
**Senate Committee on Banking, Housing and Urban Affairs**  
**Subcommittee on Securities**  
 • On  
**S.1220, The National Energy Security Act of 1991**  
**Title XV, The Public Utility Holding Company Act of 1935**

My name is Gabriel Stern. I am Director of Planning and Project Development for the Connecticut Municipal Electric Energy Cooperative, which is also known as "CMEEC" (pronounced "See Meck"). I am presenting the views of CMEEC and seventy other transmission-dependent consumer-owned utility members of the Northeast Public Power Association, or "NEPPA."

Our transmission-dependent utilities (TDUs) share with non-utility generators the role of competitors to investor-owned utilities. However, we also have a historic legal "obligation to serve" ... to meet the electric requirements of the customers in our franchise areas twenty-four hours a day.

We compete with the other utilities in the bulk power markets. However, we are often dependent on our competitors for access to transmission facilities.

The Public Utilities Holding Company Act of 1935 -- which I call here the "Holding Company Act" -- has for sixty years been the framework within which utility transactions are governed. The control of monopolistic tendencies is under oversight by of the Securities Exchange Commission. The industry also remains under the scrutiny of the Federal Energy Regulatory Commission, based on the Federal Power Act.

We do not dispute the appropriateness of reviewing and updating the Holding Company Act. But we feel improvements in the competitive process must be central to the outcome of changes.

Several forces have come into play over the last two decades. They strain boundaries set out in existing law. Electricity generation for transmission was once the exclusive province of utilities. Now a whole class of non-utility generators has entered the arena. Growth in electric load is slowing. The limits of economies of scale have been saturated for electricity generators. Smaller generation facilities are more attractive to both utilities and non-utility entities.

However, creating more competitors does not necessarily create more competition. As proposed in Title Fifteen, changes to the Holding Company Act may create more competitors. However, more power producers will be competing for limited transmission facilities. In as yet undetermined ways, the industry will be at the mercy of the utilities who control access to power markets by controlling access to, and use of, the transmission lines connecting producers and purchasers.

The situation may be an impediment, economically and otherwise, to non-utility generators such as Independent Power Producers (IPPs), access to transmission is CRITICAL to the successful operation of TDUs with their obligation to serve all of the customers in their franchise area. Limited transmission access is a vital concern of the TDUs.

Proposed amendments to the Holding Company Act contain three critical deficiencies which must be remedied in any revamping of the statute:

- 1) Title Fifteen does not address the central role of transmission access in promoting fair competition. Instead, it permits utilities to use their transmission monopolies to defeat competition.
- 2) Title Fifteen does not bar utilities from self-dealing or from using corporate structure to avoid regulation. It does not distinguish between non-utility IPPs and Affiliated Power Producers, (APPs) -- power generators directed affiliated with a traditional utility.
- 3) Title Fifteen does not address how to incorporate purchases from the so-called "Exempt Wholesale Generators" into least-cost power supply planning.

It is position of CMEEC and NEPPA that amending the Holding Company Act must incorporate legislative action to make TRANSMISSION ACCESS and COORDINATION OF PLANNING AND OF SERVICES available to all public and private utilities. The availability must be on a long-term, fair, and equitable basis to avoid further monopolization of the electric utility industry.

Transmission, unlike generation, displays characteristics of a natural monopoly in that a single system can provide transmission services more efficiently than can multiple facilities. Not only is avoidance of duplicate transmission systems necessary for economic reasons, it is essential for the protection of the environment of health and safety, and of aesthetic and land use resource values.

Methods to foster competition will improve efficiency in the bulk power market. They will not affect the allocation of transmission services. Transmission service is a product distinct from bulk power supplies. It requires distinct regulatory treatment.

Under the current regulatory scheme, the TDUs have recourse only to the Federal Energy Regulatory Commission (FERC) on matters related to transmission access. The legislative authority of the FERC to order wheeling and transmission service is unclear. The authority is being tested and probed in lengthy, complex case-by-case processes.

Recent litigation in the acquisition of Public Service of New Hampshire by Northeast Utilities -- Connecticut's major power supplier -- points up the need for streamlining jurisdictional resolution of questions involving priority to transmission access. It emphasizes the point that increasing the number and type of competitors without resolving the issue of access to markets does nothing to improve competition.

The proposed amendments in Title FIFTEEN do not make clear distinction between "exempt wholesale generators" who are affiliated with utilities and those who are not. To the contrary, the amendments make reporting and documentation of the affiliations of corporations involved in bulk power supply even more obscure.

It is critical that utilities which control transmission access be prevented from unfairly favoring their affiliates and subsidiaries at the expense of TDUs. The affiliated non-utility generators can absorb limited transmission capacity to the detriment of customers. The purchase and delivery of lower cost power can be hampered by saturation of transactions which transmit non-utility generators' power to other locations. The customers of local utilities, who have paid for the transmission facilities will suffer economically. Therefore, any proposals to revise the Holding Company Act should clearly ban self-dealing. They must also protect against abuse by ensuring that all records of a holding company are subject to prior review and action.

The scope of economically and technically feasible generation varies in different regions of the United States. Regional environmental and economic issues must be given appropriate regulatory oversight by state regulators. The appropriate division of jurisdiction between the federal and state regulators must be delineated by the debate over revisions to the Holding Company Act.

The proposed changes in Title Fifteen limit the ability of utilities to pursue integrated resource planning. Integrated planning, however, is essential. Extreme caution is required in changing a federal framework which allows such planning, especially in the critical economy of the 90s.

**STATEMENT**

**Gabriel B. Stern, Director of Planning & Project Development  
Connecticut Municipal Electric Energy Cooperative (CMEEC)**

on behalf of  
CMEEC and the Northeast Public Power Association  
before the  
U. S. Senate  
Committee on Banking, Housing and Urban Affairs  
Subcommittee on Securities  
on  
S.1220, The National Energy Security Act of 1991

**September 17, 1991**

**I. INTRODUCTION**

Mr. Chairman, my name is Gabriel B. Stern. I am the Director of Planning & Project Development for the Connecticut Municipal Electric Energy Cooperative (CMEEC), a joint action agency that serves the bulk power needs of public power systems in Connecticut. I am testifying today on behalf of CMEEC and the Northeast Public Power Association (NEPPA).

My testimony addresses the consumer and competitive concerns associated with amendments to the Public Utility Holding Company Act (PUHCA) as proposed in Title XV of S.1220, The National Energy Security Act of 1991. The most important component of these consumer and competitive concerns is the availability of fair transmission access.

NEPPA is the regional service organization representing 70 consumer-owned electric utilities and joint action agencies in Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, and Vermont. These consumer-owned utilities provide electric power to over one million citizens in the Northeast, and to several key governmental and industrial customers.

The position of NEPPA and CMEEC is that amendments to the Public Utilities Holding Company Act of 1935 as set forth in Title XV of S. 1220 must be accompanied by legislative action to make transmission access and coordinated services available to all public and private utilities. Access and services are needed on a long-term, fair, and equitable basis to avoid anti-competitive abuses in the monopoly power of the electric utility industry.

The last two decades have introduced a period of turmoil, change and uncertainty into an electric utility industry once characterized as conservative, predictable, and stable.

The consumer-owned utilities have a long, well-documented history of providing economically priced and reliable power to their customers. Without a continuation of solid regulatory oversight and clearly-defined access to transmission, that historical ability of consumer-owned utilities will be compromised.

The passage of certain of the so-called PURPA amendments in 1978 paved the way for independent power producers (non-utility generators). These amendments have resulted in some further generation competition, although not necessarily to the extent and in the manner envisioned. This legislation did nothing to solve the transmission needs of TDUs and other utilities.

A more competitive electric utility industry, properly harnessed to benefit all consumers, holds promise for reliable service at reasonable prices. Such factors are imperative for continued growth, particularly in the Northeast. In general, the smaller utility systems represented by NEPPA will benefit from competition if the competition is fair for all competitors.

Amending long-standing legislation is always fraught with peril. We must remain vigilant that in making such amendments we don't undermine effective relationships and protective oversight. The proposed amendments to PUHCA, if implemented, could have broad and perhaps negative effects on the evolution of the utility industry. The Title XV

provisions purport to alleviate constraints on competition in generation and the sale of electricity. We do not think this is the case.

The points we believe to be flawed in Title XV of the National Energy Security Act are summarized below and in the testimony which follows:

1. Title XV of S.1220 does not address the central role of transmission access in promoting fair competition. Instead, it permits utilities to use their transmission monopolies to defeat competition.
2. Title XV of S.1220 does not bar utilities from self-dealing or from using corporate structure to avoid regulation. It does not distinguish between essentially non-utility Independent Power Producers (IPPs) and Affiliated Power Producers (APPs), those producers affiliated with a traditional utility.
3. Title XV of S.1220 does not address how to incorporate purchases from the so-called "Exempt Wholesale Generators" into least-cost planning.

## II. THE PERSPECTIVE OF THE TRANSMISSION-DEPENDENT UTILITY

My testimony is offered from the perspective of transmission-dependent utilities (TDUs). A TDU is a utility that must use the transmission facilities of others to meet the requirements of its customers. A TDU, in a traditional sense, like CMEEC, can be completely surrounded by another utility that has the ability to prevent or limit access to the outside. More recently, TDUs have functionally come to encompass those utilities who require transmission to obtain resources throughout a larger region, sometimes well beyond the immediate service territory of the surrounding utility. As the development of competitive "markets" in bulk power has progressed, as has been the case for New England, sales occur on an hourly, daily, weekly, monthly and yearly basis from generation sources throughout New England and from some of the adjoining provinces and states, often at great economy for the consumer. According to testimony in the recent NU merger case, there were roughly 1400 transactions per week within NEPOOL alone.

The small systems represented by NEPPA embody, in one organization, all of the characteristics of major participants in this debate. For example:

1. Like IPPs, we represent an important alternative to large investor-owned utilities, competing directly in the wholesale market. But unlike IPPs, we also compete directly in the retail market. Perhaps even more importantly, we fulfill a legislative intent for "yardstick competition." Yardstick competition occurs when regulators and consumers of a regulated investor-owned system compares its rates and service to that of comparably situated neighboring consumer-owned utility systems. We have provided such important competition since the beginnings of the utility industry.
  2. Like IPPs, we cannot compete in bulk power supply markets without fair access to the transmission "highways."
  3. Like independent power producers, we are direct competitors of the large utilities that control the transmission highways.
  4. Like large investor-owned utilities, we have the legal obligation to meet all of the power supply needs of our retail customers. This obligation is a condition of the franchise granted all utilities.
  5. Like large investor-owned utilities, we must efficiently assemble an array of generation, transmission, and distribution resources in order to operate reliably and economically as an integrated system.
  6. Like large investor-owned utilities, we find that the imperative of attempting to meet our customers' needs reliably and economically means that we must engage in more and more hourly, daily and weekly transactions and long-term contracts in the regional market throughout New England, and with New York, Pennsylvania and some of the Canadian Provinces.
- III. ANY PUHCA LEGISLATION MUST ENSURE FAIR WHOLESALE TRANSMISSION ACCESS



**A. Wholesale Transmission Access is the Key to Fair Competition**

Some claim that certain amendments to PUHCA, as proffered in Title XV, would open up the market to new unregulated players and would -- in itself -- create a more competitive market. This is a flawed notion. Creating more competitors does not in itself translate into greater competition.

It is the regional transmission network which has the greatest impact on the ability of competition to occur. The transmission systems are the arteries of the electric utility industry. As the National Energy Strategy explains:

*"Limited access to transmission facilities inhibits the efficient use of current generating capacity and hinders construction of new capacity. In particular, limited access impedes development of competitively supplied generation resources...Increased access to electric transmission facilities for wholesale power buyers and sellers would increase economic efficiency by facilitating procurement of the lowest cost resources from both utility and nonutility suppliers. Greater access to transmission facilities would also increase competition in wholesale markets and ensure that the Nation's industries, shops, and residences have access to electricity at the lowest reasonable cost."*

For transmission-dependent utilities, such as the seventy entities in NEPPA, competitive alternatives are severely limited without transmission access. These utility systems typically have small service territories circumscribed by community or long standing territorial boundaries. The need to obtain access to electric generation resources located outside their territory, and frequently beyond the territory of the surrounding utility; growing environmental awareness and the difficulties of siting efficiently-sized generation generally mean that it is not feasible to site such generating resources within smaller communities. Also, the economics of scale generally favor units larger than most smaller utilities can prudently undertake for themselves.

The surrounding transmission owner, however, can use several means to discourage potentially efficient wholesale power transactions by TDUs. The most extreme method is to deny access to the entity requesting transmission service. Another method is to provide transmission service that is not sufficiently reliable or that is offered for far too limited a term.

In addition, transmission can be priced artificially high, so that proposed power sales or purchases are no longer economic. Most importantly, a transmission owner can set access and pricing conditions which protect his own wholesale sales and purchases from competition -- while minimizing his own retail rates preferentially compared with the rates of his neighbors.

Furthermore, transmission, unlike generation, is a natural monopoly. Avoidance of duplicate transmission facilities is necessary for economic reasons. It is also understandably essential for the protection of environmental, health and safety, aesthetic and land-use concerns.

Competition increases efficiency in the market for bulk power supply. However, since transmission -- in contrast with bulk power generation -- is a natural monopoly, we cannot expect market forces to provide the nondiscriminatory access to the transmission system that is necessary to achieve true competition and economic efficiency. The transmission service "highway" is a monopoly product, distinct from bulk power supply service, which must be used for the public benefit at reasonable rates.

Inevitably, oversight of transmission service requires its own legislative and regulatory treatment. The guiding principle in that treatment should be fair access.

#### B. The New England Transmission Situation

An example of the importance of transmission access was demonstrated in the recent case before the Federal Energy Regulatory Commission (FERC) involving the proposed merger of Northeast Utilities and Public Service Company of New Hampshire. The issues in this case centered on the projected effects of the proposed merger on

competition in the New England utility industry. The importance of the case is evidenced by the 60-plus parties to the proceeding.

In this case the FERC, subject to rehearing, found while examining the competitive effects of the merger that transmission services are a separate relevant product. While transmission services can be brokered separately, for many sellers and for all buyers of generation there are no substitutes for these services.

The presiding judge identified, and the FERC affirmed, subject to rehearing, that the transmission network is a key means of exercising market power. FERC Decision No. 364 found that the proposed merger would have anticompetitive effects, absent imposing conditions to mitigate the anticompetitive effects. The core of these conditions pertain to current and future transmission policies and practice.

In New England a substantial effort is underway to create a regional transmission compact agreement. This effort grew out of the desire to settle the litigation over the acquisition of Public Service of New Hampshire by Northeast Utilities.

If parties had not been required to subject this proposed merger to regulatory scrutiny, it is not likely that New England would be so engaged in this effort to establish a regional transmission compact. For many, there have been numerous years of waiting and at least two years litigating (at great expense) in the effort to achieve fair transmission access. Litigation occurs and negotiations drag on because legal obligations are unclear; if the law had been more clear that transmission access was an essential part of competition which FERC must assure, this ongoing wait might now be over.

Imagine what our economy would be like if potato farmers in Maine had to fight for years on end to get access to regional highways to sell their product in Massachusetts. All too often buyers and sellers of electricity in New England have been stymied by lack of transmission access, onerous pricing, or even inadequate facilities. The movement of electricity should and must occur as readily as the market demands.

Make no mistake, planning, establishing, operating and maintaining an efficient and reliable regional system is a complex and costly task requiring regional cooperation as well as engineering and forecasting skill. It is apparent that the bulk of utility capital investment in the recent past has been in the generation portion of the business - both from utility and IPP sources. While at one time investment was equally divided between generation, transmission and distribution - the balance has swung to generation investment. It is unclear how much of that investment may have been averted through more attention to transmission access and more regional planning and transmission construction. The social welfare dictates that the issue of transmission access must not be viewed in isolation from renewed regional and national focus on transmission adequacy.

C. FERC's Transmission Authority

The Commission's authority to impose conditions in the aforementioned merger case stems from its authority under Section 203 of the Federal Power Act (FPA) to condition mergers to make them consistent with the public interest.

Even while FERC has found transmission service to be a key ingredient to a competitive market, FERC has construed its authority narrowly. It concludes that presently it may only order transmission owners to provide service for wholesale buyers and sellers in limited circumstances such as a merger. The FERC does not now have explicit authority in most cases to order transmission owners to increase their transmission capacity to accommodate requests for transmission service. Whether and to what extent this authority is implicit in the FPA has been the subject of conflicting court decisions. As a result, the Commission has been hesitant to order transmission access, even where it is clearly necessary to prevent damage to competition.

Any legislative effort toward increasing competition in the utility industry, be it through amendments to PUHCA or updates to National Energy Strategy, must first provide FERC with clear and unequivocal statutory authority to grant fair and equitable access to transmission.

#### **D. The "Native Load" Issue**

##### **1. Introduction**

Competition in the electric utility industry is ultimately about consumers and the social good: bringing consumers the most efficient product at the lowest reasonable cost while protecting our environment. Therefore we must avoid approaches to competition that inadvertently harm consumers or the environment on an overall basis. With any change in industry structure some consumers may feel somewhat disadvantaged by, for example, some transitional loss of access and/or increased rates. In this debate it is important to consider the structural effect that the change will have and attempt to assure that the ultimate effect is increased efficiency and lower costs for all consumers. Resulting temporary adverse effects to some consumers can and should be addressed in a fair and equitable manner without unduly impeding other parties. In planning transmission policy, we therefore must find a way to increase competition in bulk power markets while recognizing each utility's obligation to continue to serve all its native customers with minimum disruption.

More broadly, transmission policy must recognize the differences between different types of transmission users. For example, the transmission needs of independent power producers and transmission-dependent utilities are very different. The IPP is a single generator. The IPP needs transmission to ship its product to its customer. A transmission-dependent utility is a fully functioning utility with all of the inherent utility obligations to provide service to its customers. TDUs, like all utilities, are responsible for supplying all the needs of all its customers. Each utility needs transmission to tie together all its generation, transmission and distribution resources in a single integrated system. Each utility is bound to financially support the regional transmission system through the years, as the transmission system grows to meet the region's increased needs.

Emphasizing this difference between a single generator and a fully integrated system takes nothing away from the IPP. IPPs do need access if they are to be able to bring new competition to our industry. But IPPs are a single component of a vertically integrated and vertically operated system. They do not have the type of

planning responsibility that all utilities have, and they do not have the same kind of need for transmission access that we TDUs have. A single IPP plant is no substitute for a fully integrated system.

Too often the concern for "native load" is cited by operating utility transmission monopolists as an excuse to perpetuate monopoly power. That, of course, is not our position. As transmission-dependent utilities, we represent a spectrum of both native load as well as long-term firm and nonfirm transmission purchasers and in many instances owners of integrated transmission facilities. We do advocate a balance between those who have paid or are willing to pay for the system (including long-term transmission customers and wholesale customers), and fair competition among those who need the system. That balance must recognize the difference between long-term needs and near-term needs, while maintaining open access to the system at fair and reasonable rates.

## 2. Long-Term Transmission Needs

Over the long term transmission owners and other utilities should plan their regional system to accommodate the full needs of a growing, competitive market, including transactions with neighboring regions. The needs of TDUs, other utilities, IPPs, QFs, etc., must be recognized. Everyone who wants transmission access should get a chance to pay for it on a long term basis; at times some should be able to pay less for a distinct, lower priority service. Those who commit to support the regional system should be able to obtain equivalent access to that system for all transactions, both long- and short-term, that occur in that market, consistent with their level of support.

All those who have supported development of the regional transmission system or are willing to pay their share to support it on a long-term basis should have equal rights to use the system and no utility should be permitted to withhold its section of the regional transmission system to gain or retain to itself a competitive advantage as compared to the needs of other participating systems. All those who wish to support the regional grid should pay their fair share of additions that are consistent with regional planning. Those who construct new generation should be responsible to provide the transmission necessary to get the generation to the regional grid. For those requiring

less than full use of the regional transmission system, the concepts of different pricing and/or different priority of access can be appropriately applied.

### 3. Near-Term Transmission Needs

By "near term," we mean the time when the present limits on transmission capacity apply. With these limits, there can be conflicting claims to transmission priorities. "Native load" is not a particularly useful concept in resolving such claims in the long term. Consider a TDU that has financially supported the development of the surrounding utility's transmission system, as a transmission customer or wholesale power customer. This TDU may require, in order to engage in a long-term transaction in the regional market or to introduce a new plant to the system, transmission capacity that the surrounding utility would prefer to leave available for its own short-term opportunity or economy transactions. In such a case, you have a transmission-owning utility's "native" retail load potentially contesting access with against its equally "native" wholesale or transmission load. Such conflict can be, and in some few instances have been, resolved through fair allocation of the existing system and joint planning to expand the system as consideration of all needs require.

The more strident of the native load claims could serve to make planning and negotiations so divisive and difficult that competition is stifled and all regional consumers lose. Developments in the generation market have made the concept of an individual utility's transmission as part of a single utility system somewhat of an anachronism. Generation and transmission additions can no longer be planned on an individual company basis in most places, and certainly not in New England.

There may be a time when the goal of treating existing transmission customers fairly conflicts with the goal of full competition. These problems should be reviewed on a case-by-case basis. No one who is capable of competing should be barred from competing. There is a potential difference in the near-term between those who have had an opportunity to reserve and pay for a long-term stake in a transmission system, and those who have not had such an opportunity. As stated above, this difference should disappear over the long-term, if future facilities are planned to

accommodate the needs of all users. In the near-term, this difference will require and is susceptible to a fair resolution.

#### E. Retail Wheeling

My comments on transmission access refer only to wholesale transmission, not retail transmission. The overall implications of these two concepts are very different. Retail transmission raises this question: What is the fundamental relationship between a utility and its native load customers? That is a uniquely local matter. Federal policy on wholesale transmission should not disrupt the current right of state commissions and local governments to define (1) the boundaries of utility service territory and (2) the mutual obligations of utilities and their customers.

#### IV. THE NEED FOR A CLEAR DISTINCTION BETWEEN IPPs AND APPs

Businesses with one foot in a competitive market and one foot in a monopoly market will always face great incentives to mis-allocate costs between competitive and noncompetitive operations. It is natural for businesses to use available means to maximize return.

In a truly competitive market improper cost allocations cannot remain in effect because customers can move to other suppliers. But as transmission-dependent utilities, we do not now have that many options. TDUs are confined by their limited-service boundaries. And some are too small to build their own generation to provide their own alternatives to unfavorable and high-priced generation sold by outside suppliers.

We therefore agree with Chairman Allday of FERC in his recent comments to the American Bar Association that there must be a policy distinction between utility-affiliates and truly independent power producers. Chairman Allday stated:

*"[T]ransmission is a natural monopoly, and will likely remain so for the foreseeable future. Therefore, even if the affiliate producer has no transmission itself, its affiliate utility may use*



*control of its transmission facilities to keep other sellers from competing.*

*Second, even if a utility affiliate can't use its transmission facilities in this manner, it may engage in cross-subsidies. No producer is independent if its affiliate can manipulate -- however subtly -- arrangements within the company to make captive customers subsidize the producer.*

*That's why we must have a separate category for any power producer affiliated with a traditional utility. We call them affiliated power producers, or APPs.*

*We've seen a wide range of proposals by APPs -- some of them present few problems and can be processed quickly. But the key point remains: we must scrutinize market power issues closely any time a traditional utility is involved."*

With investment in new plants tapering off and existing utility rate base gradually being depleted, pressures can mount from stockholders and Wall Street for greater earnings. A utility's focus can easily shift away from better serving captive retail customers to emphasis on showing greater profits. Because of disparate rate and regulatory treatments among states, utilities operating in more than one state jurisdiction, and through more than one subsidiary have an incentive to allocate costs to the jurisdiction providing the most favorable rate treatment. This poses strong enticement to transfer revenues and earnings to the least-regulated entity, and to evade regulatory oversight.

Moreover, regulators already face highly complex utility corporate structures that can frustrate effective regulatory scrutiny. As transactions become ever more complicated and as costs flow from one company to another, regulatory oversight, restraint or control of behavior which unfairly enhance the competitive position of the company as a whole becomes more difficult. It may sometimes be impossible to achieve in a single jurisdiction. Who checks to see that the same costs have not been

overallocated or misallocated between the federal and state jurisdictions or between two or more states? Is it possible to determine conclusively that this has not occurred when the costs are being recovered in multiple jurisdictions with inconsistent rules?

Regulators and customers, including wholesale customers, must have the ability under law to question the costs and prudence of transactions between holding company affiliates to prevent cross subsidization and improper allocations of costs and revenues. Proposals to revise PUHCA should carefully define the areas between monopoly and competition. They should clearly ban self-dealing. And they should protect against abuse by ensuring that all records of the holding company and its subsidiaries will be subject to review.

## V. IMPACT ON PLANNING AND ENVIRONMENTAL PROTECTION

### A. Integrated Planning Is Essential For Efficient Resource Use

The proposed revisions to PUHCA can also erode the process of integrated resource planning incorporating several public policy goals. In recent years, the process of long range planning to provide sufficient supply at a reasonable cost has addressed demand side management as well as more traditional supply acquisition strategies as modern utility planners examine the least cost route to serve their customers. This process has also incorporated other public policy goals such as minimizing environmental risks. Because many consumer-owned utilities have limited geographic boundaries, the availability of wholesale power from reliable sources is critical, as has been discussed above.

However, the geographic scope of economically and technically feasible competition will vary in the different regions of the United States. Regional economic and environmental issues must be given appropriate oversight by state regulators. The appropriate division of jurisdiction between state and federal regulators has been at issue in the debate over the proposed changes to PUHCA as set forth in Title XV. States have traditionally held jurisdiction over both generation siting and the location and necessity for associated transmission corridors.

Whenever generation options are dis-associated from the integrated utility planning process, the siting review and economic and environmental protections associated with siting oversight may be compromised. Costs to consumers can only be kept within reasonable bounds by avoiding duplication of facilities or the siting of generation which is outside technically feasible markets. Someone should have oversight to assure that the need for more power is fully considered. Without integrated planning of generation and transmission, the consumer is likely to be exposed to higher costs.

The provisions of contracts alone may not suffice to protect the ability of utilities to deliver reliable power at a reasonable cost to all customers in the franchise area. As is the case with QFs and existing IPP's, the oversight by FERC under the Federal Power Act and by state regulators assures utilities that new entrants into the arena are worthy contributors to the power supply. The public policy goals associated with fuel use, energy efficiency and environmental protection are ignored by the proposed category of "exempt wholesale generators" proposed in Title XV.

**B. Environmental Protection Priorities Must Be Maintained**

The need for judicious planning of facilities also gains importance in view of concerns about effects of electromagnetic fields associated with high voltage transmission lines. The ability to site and construct new facilities may be constrained by the need to protect citizens from unnecessary exposures. It becomes even more critical that the existing transmission corridors be allocated equitably and priced fairly.

Compliance with provisions of the Clean Air Act also imposes locally important considerations on emissions from electricity generating plants. While the siting of a generation facility may benefit an "Exempt Wholesale Generator," the use of the site and/or the allocation of allowed emissions in the immediate geographic area may preclude options needed by a local utility to serve its load or the needs of a local industry. Proposed amendments of PUHCA in Title XV remove the scrutiny and integration into planning that currently protects against a proliferation of generating units whose need is fully scrutinized.

By separating the construction of generators from the need to serve load, the process of integrated planning or least-cost resource additions is made more difficult. Important policy considerations may be obliterated in the process.

#### VI. WHAT THIS COMMITTEE SHOULD DO

If the goal of Congress is to improve competition to benefit the customer, we agree with the goal. But Congress should not expect to achieve competitive benefits through legislation which fails to take a comprehensive approach to competitive issues. Title XV, as now written, will disrupt competition, not enhance it. Therefore, the following corrections are necessary:

1. The notion of permitting utilities to expend and misallocate costs, and then discover and redress damages later, does not work. There must be advance review, case-by-case, of PUHCA exemptions.
2. There should be a ban on self-dealing, and clearly defined firewalls between the competitive and monopoly sides of the business.
3. We never fully protect against abuse through rules and regulations. You need competition. That is why we need a transmission policy. Congress must empower FERC to ensure fair access to the transmission highways by enacting the principles of the Markey-Moorhead legislation or similar proposals.

These principles are embodied in model legislation released last month by a broad coalition consisting of independent power producers, consumer and environmental organizations, industrial customers, and others. This Committee should insist that Congress enact these principles either as stand-alone legislation or as a condition of changes to PUHCA.

# ConnPIRG



**TESTIMONY OF JAMES P. LEAHY, EXECUTIVE DIRECTOR  
CONNECTICUT PUBLIC INTEREST RESEARCH GROUP  
BEFORE THE SECURITIES SUBCOMMITTEE OF THE  
U.S. SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS  
THE HONORABLE CHRISTOPHER J. DODD, CHAIRMAN**

**SEPTEMBER 17, 1991**

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My name is James Leahy and I am the Executive Director of the Connecticut Public Interest Research Group, or ConnPIRG. I would like to thank the Chairman for holding this hearing on the crucial issue of regulatory alterations in the utility industry and giving me the opportunity to be here today and contribute my remarks.

ConnPIRG is a statewide, non-partisan, non-profit environmental and consumer protection advocacy organization that works at both the state and federal levels. Founded in 1974 at the University of Connecticut, ConnPIRG joined with PIRGs throughout the country to establish a national lobbying office, U.S. PIRG, in 1984. ConnPIRG's door-to-door outreach campaigns have identified over 75,000 members throughout the state of Connecticut.

#### I. INTRODUCTION

As you know, Mr. Chairman, consumers of electricity are captives of the rates charged them by their local utility. Numerous legal decisions and affirmative acts of Congress in this century have established the right of consumers to protection against abusive pricing practices by utilities enjoying publicly sanctioned monopoly. Toward that end, the right of states to regulate activities of and acquisitions by utilities in their jurisdictions became a fundamental lever of consumer protection. Passed in 1935, the Public Utilities Holding Company Act (PUHCA) codified these concepts and has served as one of the pillars of ratepayer protection in this country.

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PURCA was passed in response to the anti-free-market morass of the 1920's and early 1930's in which utilities used creative pricing and conglomerative techniques to consolidate power over utility markets and customers. Such abusive practices -- such as the "milking" of electric and gas utilities by parent holding companies -- were labeled by Congress to be significant contributors to the 1929 stock market collapse and the subsequent Great Depression. Such practices and the motivations behind them have not gone away. They have, if anything, become more creative.

As applied 55 years later, PURCA is not a perfect institution for accomplishing the goals of the Act, which include:

- \* barring expansion which monopolizes new territories or creates risks to consumers or investors;
- \* requiring that acquisitions tend toward "the economical and efficient development of an integrated public utility system;
- \* limiting speculation in unrelated ventures where that speculation imposes risks on consumers and investors;
- \* guarding against corporate structures which impede effective state regulation;
- \* prohibiting transactions between affiliates, except at cost;
- \* and mandating advance SEC review of certain transactions.

However, bad actors in the the utility industry continue to underscore the vital role that PURCA plays in assuring a competitive, efficient utility system -- one which operates in the public interest, rather than in the interest of a few companies which feel constrained in their profit-making ability, and are thus out to gut the law.

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For that is what is happening, Mr. Chairman, in the form of the PURCA provisions of S. 1220, the National Energy Security Act of 1991. In the name of competitiveness, the "reform" efforts of S. 1220 would severely hamper the true competitiveness which produces an efficient and innovative market and which guarantees essential protection of consumers. The competitiveness which the "reformers" seek to achieve is the ability to dominate PURPA-sanctioned independent power producers (IPPs) and control prices by creating a class of generators which will be exempt from regulation by state utility commissions.

If there is a doubt that such abuses will actually take place, there are many recent examples of ways that specific utilities have already sought to circumvent the rules under PURCA through self-dealing between affiliated producers and utilities, and impairment of state regulatory authority. Each of these has resulted in the same risks to ratepayers that the Act was originally designed to prevent. The record provides ample evidence that loosening PURCA restrictions will result in an increase rather than a decrease in these practices.

This is not to say that there have not been encouraging trends in utility systems over the past several years. The adoption of least cost planning programs in more than 19 states have served to bolster the protection of consumers and save utilities the hazards of over-investment in costly and unneeded generating capacity by seeking out the cheapest source of power. State authority to develop and enforce integrated resource plans must be protected --



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rather than put at serious risk by plans such as S. 1220. Coupled with the continuing development of new technologies and innovations, these trends have mapped a bright future for an efficient, competitive power grid.

I am not saying that PURCA cannot be improved. The next step in realizing the intent of the Act and of PURPA's design for getting IPPs into the market is to ensure that nondiscriminatory transmission access can occur. In order to satisfy the stated goal of an efficient, competitive market and the ensuing protection for consumers, the FERC must be able to order transmission access for legitimate wholesale producers.

In addition, the severe restriction of self-dealing is absolutely necessary to prevent the kinds of abuses that exist under the present system. The examples of Consumers Power and Southern California Edison are each stunning in the complexity of affiliate transactions, the lengths that the utilities have gone to avoid regulation, and the subsequent risk these episodes brought upon ratepayers.

The underlying principle behind PURCA is that the degree to which the market for power is free and competitive directly translates into the level of protection for consumers and ratepayers. Any alterations that we make in PURCA should be toward the goal of a genuinely competitive market. Transmission access and restriction of self-dealing are among these. Conversely, the changes sought in S. 1220 would move in the opposite direction, toward restricted and collusive markets, rife with opportunity for abuse.

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ConnPIRG urges the Committee to seek the deletion of the existing PURCA provisions in S. 1220 and substitute amendments that would: 1). prohibit self-dealing between utilities and affiliates; 2). empower the FERC to order transmission access in specific cases; and 3). secure the right of states to protect their consumers and ratepayers under their conferred monopoly by exercising prudence review of acquisitions of power by their utilities in any transaction that could affect state electricity rates.

## II. SELF DEALING

Perhaps the most potent vehicle for evading PURCA protections and thus endangering ratepayers is the ability of holding companies to make power purchases between affiliates exempted under PURPA as wholesale "Qualifying Facilities" (QFs). While PURPA has given utilities the right to own wholesale facilities and purchase from them, their exemption from state regulation puts state public utility commissions in a nearly impossible position to effectively monitor the ongoing financial activities of utilities and holding companies as they are mandated to do under the Act.

If expanded by changes such as those in S. 1220, the ability to self-deal can stop cold in its tracks the positive trend in states toward finding the cheapest source of power to meet increasing demand. This would be accomplished both by hindering state power to enforce integrated management plans and by the easier climate for adding new generation facilities -- still sought by many utilities over the adoption of efficiency measures

Self-dealing puts utilities in position of purchasing power in non-arm's-length negotiations which have many times in the past led to abusive pricing practices and anti-competitive tactics. The sad legacy of the drive by Consumers Power to load an unneeded 250MW onto the backs of Michigan ratepayers is the Michigan Public Service Commission's (MPSC) famous comment that, "one must wonder whether Consumers Power has once again negotiated with itself and lost."

Though ordered to undergo a competitive bidding process to fill its need for additional power, Consumers elected to charge outside producers \$10,000 each to enter the negotiation process. In addition, according to the MPSC, the unacceptable terms put on the table for bidders by Consumers was the result of their desire to self-deal. MPSC ultimately determined the Consumers Power actions to have put ratepayers at considerable risk of paying for unneeded power.

Consumers Power is but one of a number of examples of how self-dealing has undermined state regulatory rights, thwarted competition and put consumers at risk of paying unfair prices for electricity. Though it is an extreme case, it illustrates the lengths that a utility can go in attempts to pad its bottom line. The codification of the opportunity for utilities to engage in such practices sought by the exemption of wholesalers in S. 1220 is to open a virtual Pandora's Box of abuse for consumers and ratepayers.

### III. TRANSMISSION ACCESS

The achievement of genuine competition and the realization of the intent of the QF exemption under PURPA requires that IPPs can get their product to market. The attainment of the least-cost planning principle mandates that the most efficient producers can in fact be utilized by the power system. However, under the present framework, transmission access is not guaranteed for small utilities, municipal and cooperative systems, cogenerators and other small and independent power producers. Since transmission facilities are monopoly facilities, FERC should be able to order transmission access in specific cases. We urge you to support legislation that would give the Commission this authority.

Nondiscriminatory transmission access promises more efficient generation and lower costs to consumers. Open transmission enables utilities to purchase the cheapest power available in any given hour, thus enhancing competition and offering consumers a better price for electricity. Available low-cost power also inhibits the construction of additional unneeded generating capacity.

The ability of utilities to block producers from the market has been demonstrated all too often. Aided by self-dealing -- and the ability thereby to concoct a sweetheart deal -- utilities can and have purported to be buying more efficient power from QFs when, in fact, they have been dealing with affiliates to keep the most efficient producers out of the market. I return to the sad story of Consumers Power, and the utility's quickness to wheel power only for its affiliate and deny access for non-affiliated QFs.

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The theory that loosening PURCA restrictions under S. 1220 would improve transmission access through competition defies common sense. The incentive lands clearly on the side of providing access to affiliates and denying it to competitors. They can do this by imposing tougher contract terms, fulfilling PURPA obligations by simply purchasing power only from their affiliates, or providing design and engineering services to affiliates at low prices, giving them the competitive edge. If this kind of discrimination was something new or undocumented, the argument might stand up better. However, the restriction of transmission access is well documented.

**STATE REGULATION AND LEAST-COST PLANNING:**

The case for least cost energy planning is a pro-competition, pro-consumer, and pro-environment argument. Generators strive to supply the best deal to purchasers, less polluting fossil fuel is burned as cheaper efficiency options are employed to generate electricity, and captive consumers pay a lower price for their power. It is a win, win, win situation.

However, the institution of successful least-cost planning depends on strong state regulation under PURCA. Corporate restructuring to avoid regulation under the Act -- and the subsequent transfer of much regulatory authority from the states to the FERC -- has made it considerably more difficult for states to supervise utility dealings as required by law. The complexity of asset transfers, exchanges of services, and other activities between affiliates -- sometimes in faraway states -- has severely

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taxed states' ability to get the information they need to effectively regulate.

The examples of Consumers Power and Southern California Edison demonstrate that state regulation is being circumvented under the present regulatory structure. However, the incorporation of changes in S. 1220 would significantly increase the difficulty for states to effectively monitor the activities of holding companies and utilities, as well as pre-empt them from the review of interstate power purchases, no matter what excessive costs might go into the price to consumers.

Such developments would, in turn, hamper the ability to enforce least-cost plans. Under S. 1220, utilities can use their affiliates to evade their legal obligation to provide the lowest cost power to captive customers. Again, the idea that -- given the choice -- a utility would purchase power from a lower-cost generator, rather than deal with an affiliate, flies in the face of common sense. The affiliate would produce the lower cost power and sell to the parent at the utility's higher avoided cost, thus diverting the savings from captive customers to shareholders.

Connecticut has been a national leader in least cost planning and currently has a progressive, collaborative planning structure. It is a long term process which considers energy supply, demand, efficiency, and environmental costs in providing for the state's energy future. The Connecticut process relies heavily on conservation efforts, and the cooperation of Northeast Utilities (Connecticut Light and Power), United Illuminating, state agencies,

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and the Conservation Law Foundation. In 1990, the two utilities filed conservation programs amounting to over \$34 million.

Because of its current success, promise for the future, and early stage of existence, ConnPIRG does not support the endangerment of the Connecticut least-costs planning program by renewed opportunity for construction of risky, unneeded, generating capacity as envisioned by S. 1220. In addition, as effective least-cost planning depends on strong state oversight, we oppose the chilling effect that S. 1220 would have on the state's ability to oversee transactions by its utilities.

**U.S. SENATE SUBCOMMITTEE ON SECURITIES**

**SEPTEMBER 17, 1991**

**TESTIMONY OF JAMES F. CROWE**

**ON BEHALF OF**

**THE UNITED ILLUMINATING COMPANY**

**ON**

**TITLE XV OF THE NATIONAL ENERGY SECURITY ACT:  
AMENDMENT OF THE PUBLIC UTILITY HOLDING COMPANY ACT**



UNITED STATES OF AMERICA  
BEFORE THE  
U.S. SENATE SUBCOMMITTEE ON SECURITIES

My name is James F. Crowe. I am Senior Vice President of the United Illuminating Company (UI). UI is the second largest electric utility in the State of Connecticut, serving a quarter of our state's population with a service territory of about 335 square miles.

I want to thank the Committee for providing UI with the opportunity to comment on Title XV of the National Energy Security Act and the effort underway to reform the Public Utility Holding Act (PUHCA). We have very significant interest in these developments since we serve the greater part of Connecticut's manufacturing base, that is, employers who are struggling to compete in one of our region's worst-ever recessions.

As you are now aware, PUHCA reform is very controversial. Advocates of reform argue that such reform will promote additional power supply options and increase competition in wholesale electricity markets. Opponents question the need for reform and caution against the demise of the vertically integrated utility that has, without any doubt, served this nation so well. This controversy threatens to split investor-owned utilities into two hostile camps.

UI is not as yet in either camp. UI is not a member of either the Electric Reliability Coalition or any of the organizations that

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comprise the PURCA Reform Coordinating Counsel. UI is not either a just say "yes" or just say "no" company.

UI is not afraid of competition. Although competition has made life tougher for us as employees, I can also tell you that because of competition, we are doing a much better job for our customers. Competition has become a fact of life for the electric utility industry and the challenge is to harness competition to promote improved efficiency, service, and coordination without adversely affecting reliability or causing customers unnecessary additional expense.

In this regard, UI has several concerns about the current initiative to reform PURCA. Title XV and the other proposals circulating around Congress will create a new class of electric power generating companies that will be exempt from PURCA. The ostensible purpose of this exemption is to enrich the generating options available to utilities. Proponents of reform argue that Title XV will not require utilities to purchase power from these deregulated suppliers -- and thus will not force a restructuring of the electric utility industry or result in undue reliance on non-utility power producers.

UI believes this position is too simplistic. It is impossible to divorce this legislation and the introduction of greater numbers of non-utility power suppliers from the subjects of industry structure, transmission access, reliability of service, stranded investment, undue competitive advantages and, most importantly, the

possibility of higher rates to residential and commercial customers.

In an ideal world, a utility would review the power options available to it and select the combination, including building its own plants, that most economically satisfies its customers' needs. In such a world, eliminating PURCA regulation for suppliers dedicated to the wholesale market could improve the options available to utilities without adversely affecting the quality and cost of electric service. Power suppliers would compete on a level playing field without benefit of competitive advantages that are unrelated to the quality of the company, fuel or technology. Utilities would be free to choose power suppliers that best meet their customers' needs, including being able to pay a premium for project features that are particularly attractive, such as dispatchability, reliable management, and strength of financing.

Unfortunately, this is not the world within which electric utilities operate. Investor-owned utilities, such as UI, are subject to pervasive regulation. We are generally vertically-integrated utilities (we own generation, transmission and distribution) that have been granted franchises to serve customers within defined geographic areas. In return for the franchise, we have accepted an obligation to reliably serve all customers within the franchise, have our rate of return limited, and have virtually every aspect of our activities closely scrutinized.

Indeed, certain decisions are not even ours to make -- such as having to purchase power from particular power suppliers or

restricting the extent to which our activities can be financed through the issuance of debt. Other decisions, while theoretically within our discretion, are heavily influenced by federal and state regulators. For example, we are only able to recover expenses from our customers if our federal and state regulators conclude that such expenses were prudently incurred. In other words, rate regulators can prevent utilities from recovering their costs if they disagree with how utilities have spent their money. Needless to say, this gives regulators a great deal of leverage over utilities' procurement decisions.

As a result, it is not really accurate to say that utilities will be free to choose whether or not to buy power from the suppliers meant to be encouraged by PURCA reform. Title XV and the other proposals will not relieve electric utilities from their regulated status or their obligation to serve. Nor do these proposals create a fair competitive free market at the generation level. Therefore, the introduction of more non-utility suppliers could very well result in biased decisions that will result in utilities and their customers becoming hostage to highly leveraged non-utility generators and electric rates far above what they would otherwise have been.

Let me provide you with a few examples of how the current scheme for regulating utilities could result in such a biased and costly result.

First, there is the Public Utility Regulatory Policies Act of 1978 (PURPA). This law compelled utilities to offer to purchase

power from a certain privileged class of power producers -- called qualifying facilities or QFs -- that produce power utilizing cogeneration or renewable resources. This law has often been cited as an unprecedented success and the precursor of the current drive to expand the number of deregulated power suppliers.

This law was a success -- but not completely so. Many utilities, including UI, have been forced to purchase power that they did not need or to pay rates far in excess of the value of the power being bought. In some cases, regulatory commissions have set the price of power for such purchases far above what could have been purchased in the wholesale market and above the cost to the purchasing utility of building its own plants. In other cases, state legislatures have promoted selected technologies through inflated prices. These abuses have been documented in both Congressional hearings and in proceedings before the Federal Energy Regulatory Commission (FERC). Rather than recap all of these abuses, I would be pleased to submit this material to the Committee. Suffice it to say, however, that these abuses continue, and UI is still having to buy power from QFs that it does not need and at prices greater than the cost of producing the power for ourselves.

Advocates of PUHCA reform will try to distance PUHCA reform from the problems of PURPA by saying that the purchases under PURPA were mandatory and PUHCA reform will not mandate any purchases.

This distinction is not meaningful. Although the purchases under PURPA were mandated, there were protections written into the

law that, had they been honored by regulatory commissions and state legislatures, would have protected utilities from buying capacity they did not need or from paying excessive rates. The fact of life that utilities most deal with every day is that well meaning legislation, such as PURPA, is subject to biased application by regulators.

Second, many have argued that the competitive environment that now characterizes the power industry will protect against undue reliance on non-utility power suppliers. These same advocates cite as support for their position the fact that competitive bidding programs have made the problems with PURPA a thing of the past. Theoretically, bidding programs that allow all potential sources of power to compete will produce the most advantageous rates for purchasing power and also satisfy the PURPA restriction that QF rates should be no more than utilities' avoided cost, that is, the rate for the power that utilities would have bought but for their purchases from QFs.

Of course this solution, as well as the avowed neutral impact on utilities of any PURPA reform, rests upon the assumption that regulators are willing to refrain from interfering with competition. Recent action by the Massachusetts Department of Public Utilities (MDPU) confirms my suspicion that this is an unrealistic assumption. Boston Edison Company recently solicited proposals for the purchase of power under a long-term contract. The MDPU ruled that utilities could not compete for the sale of

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power despite the fact that several utilities, including UI, are established suppliers of diverse and reliable wholesale capacity.

Obviously, not permitting utilities to compete for the sale to Boston Edison shelters from competition those permitted to participate in the solicitation and can only have the effect of raising the cost of power to Boston Edison. It is equally obvious to me that since many of the proponents of PUHCA reform are also entities that benefit from QF status, that these entities will be advocating regulatory policies similar to that adopted by the MDPU -- policies that will make it difficult for utilities to compete with non-utility power suppliers. In this regard, it is interesting to note that certain trade associations representing non-utility power producers are reportedly asserting that competitive bidding is driving their profit margins too low.

Third, utilities' are limited by regulation as to the extent that they may finance the construction of new power plants through the issuance of debt. Non-utility generators, such as QFs and the suppliers intended to be encouraged by PUHCA reform, are not so limited. This could create some very significant problems. This restriction will handicap utilities ability to compete with non-utility suppliers. The ability to debt finance projects to a greater degree than utilities could reduce non-utility suppliers' costs by, according to testimony presented to the Senate Committee on Energy and Natural Resources, as much as ten percent (10%) -- thus providing such suppliers with an undue competitive advantage.

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Will this advantage become significant? Absolutely. Regulators will always be under significant pressure to keep electric utility rates as low as possible. A cost differential of five to ten percent (10%) will not be able to be ignored -- even though there may well be hidden costs associated with relying on non-utility sources of power.

What are these hidden costs? A couple come immediately to mind. A utility relying on third party sources will have to protect against the possibilities of supply failures by having greater reserve margins (the amount of extra generating capacity held in reserve) to maintain its credit rating. Thus, relying on non-utility generation will cost money -- either to arrange for the additional reserves or through increased cost of capital due to lower credit ratings. Furthermore, Standard & Poor has reportedly announced that a utility that relies on non-utility generation for more than ten percent (10%) of its power needs will have all of its long-term firm capacity payment obligations assigned to its balance sheet as debt, thus further increasing the utility's cost of capital.

Thus, there are several ways in which the current regulatory regime could and probably would result in biased decisions and undue reliance on highly leveraged non-utility power suppliers. These concerns cannot be lightly dismissed as merely the protestations of companies that do not want to face the challenges of competition.



Indeed, at least from UI's perspective, PUHCA reform is not about whether or not one believes in competition. UI does. The real issue is whether Congress, in enacting PUHCA reform, will also act to create a fair and truly competitive wholesale generation market. PUHCA reform without such action will merely exacerbate the problems in power procurement that already exist. PUHCA reform with such action will not only achieve the avowed goals of reform, but could also make a significant contribution to the mission of all utilities -- which is to provide the best electric generating, transmitting and delivery system and the most secure, reliable and economic supply of electricity.

To achieve this goal, however, any legislation to reform PUHCA must also ensure that all power producers, including investor-owned utilities, can compete on a level playing field where competitive advantages are not extended to particular suppliers by virtue of their privileged legal status or parochial regulatory policies. In this regard, UI respectfully, suggests that any legislation regarding PUHCA include the following reforms:

- (1) Eliminate Or Restrict The Privileged Status Afforded QFs By PURPA.

The avowed goal of PUHCA reform is to increase the generation options available to utilities and promote competition. The mandatory purchase obligation under PURPA and the possibility of rates that are higher than avoided cost obviously conflict with this goal. The easiest solution would be to amend PURPA to eliminate the mandatory purchase obligation. This would place QFs

on the same footing as all other power suppliers, at least to the extent that they will only be able to make power sales if they are willing meet and match their competition.

Alternatively, there are other ways to minimize the competitive distortions caused by QFs, such as: (a) limiting capacity payments to when utilities need new capacity as established consistent with utilities' planning horizons; (b) requiring avoided cost rates to be based on all other wholesale sources of power, including the purchasing utility's own generation, taking into account the qualitative characteristics of power, including reliability, dispatchability, and fuel source; and (c) prohibiting states from setting rates for QF power above utilities' avoided cost by codifying FERC's still-stayed Orange & Rockland decision.

None of these suggested reforms is new. Indeed, all of these reforms were proposed by FERC in 1988. All of these changes are intended to refine implementation of PURPA without changing the thrust of PURPA. Indeed, these changes are necessary to ensure PURPA is implemented as originally envisioned. Unfortunately, FERC has failed to complete the job. The job needs to be completed to create the competitive generation market upon which PURPA reform should be premised.

(2) **Minimize Regulatory Commission's Ability  
To Interfere With The Competitive  
Wholesale Generation Market.**

As explained above, there are a variety of ways regulatory commissions can interfere with competitive wholesale generation

markets. Such interference can range from action as blatant as that of the MDPU restriction as to who is allowed to compete to more subtle interference, such as a regulators' restrictions regarding how utilities finance their participation in power projects. Obviously, as long as utilities remain regulated, it would be impossible to eliminate the possibility of regulatory interference with the market. However, Congress should identify and protect against the most egregious possibilities.

Clearly, Congress should not permit competitive solicitations to exclude offers by utilities. It's hard to believe claims that PUHCA reform will not prejudice any particular form of industry structure if non-utility generators are sheltered from competition from utilities. Utilities must be allowed to compete with non-utility generators. This is true for both self-generation and sales to other utilities. Utilities should not have to buy power from non-utility generators when utilities can produce the power for themselves more cheaply. Utilities should also be guaranteed an opportunity to compete with non-utilities for sales to other utilities. Any PUHCA legislation should be express in this regard.

Further, non-utility generators should not be afforded a competitive advantage by virtue of regulators' restrictions as to the degree to which utilities can finance projects through the issuance of debt. Senator Conrad suggested an amendment to the Senate Energy and Natural Resources Committee during that Committee's consideration of Title XV that would have achieved this result and protected utilities against highly leveraged projects.

A Conrad amendment would have required a power supplier exempt under Title XV to restrict its use of debt financing to the same extent as the purchasing utility.

Senator Conrad's amendment was not added to Title XV. Although I do not necessarily endorse that amendment, I commend his recognition of this problem. I do not believe that Section 15107 of Title XV adequately addresses this issue. All this section does is require state commissions to perform a general evaluation of the effects on relying on highly-leveraged power projects. More studies will not protect us or our customers.

This issues warrants additional investigation by Congress. It would be unfortunate if those power producers with the most experience and legal obligation to serve, investor-owned utilities, are precluded from being able to meaningfully compete with non-utility power suppliers because their regulators handicap their ability to leverage investments in power projects.

There are a variety of different approaches that should be explored. PUNCA reform could require regulatory commissions to set the maximum amount of debt leveraging that would be permissible as part of competitive solicitations of power. The ceiling would be discretionary -- but would then apply to everyone alike, including the purchasing utility. Alternatively, Congress could choose to leave the degree of debt financing unrestricted -- but then guarantee that utilities could also engage in unrestricted debt financing -- at least when a utility has set up a subsidiary to develop a power project on a non-recourse basis.

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- (3) **Ensure Utilities Retain The Management Discretion And Authority To Determine How They Will Meet Their Legal Obligation To Serve, Including The Extent To Which Utilities Will Rely On Non-Utility Suppliers Of Power.**

Advocates of reform insist that Title XV and the other proposals will not force utilities to purchase from non-utility producers. I have no doubt that Senator Johnston and other supporters of Title XV are sincere in the belief that utilities will retain full control over their procurement programs despite enactment of PUHCA reform.

I also have no doubt, for the reasons outlined above, that utilities will be pressured into purchasing from non-utility suppliers through the threat of prudance disallowances in wholesale and retail rate cases. In this regard, it is noteworthy that a provision originally included in Senator Johnston's proposal to reform PUHCA, that would have permitted utilities to opt out of purchasing power from power producers exempt under that proposal, was not included in Title XV.

Obviously, there is a very delicate balance that must be struck between utilities' need to be able to manage their operations and regulators' need to responsibly regulate. I am certainly not suggesting that regulators should not be able to disallow recovery of obviously imprudently incurred costs. On the other hand, any legislation to reform PUHCA must include some protections against utilities being driven into unduly relying on non-utility power suppliers, as many utilities have been driven

into purchasing power from QFs that was either not needed or priced far too high.

Frankly, I am not sure how this balance should be struck -- but the difficulty of the issue does not justify ignoring this problem. We have time to work on this issue. There is no pressing problem that compels PUNCA reform immediately. One approach that should be explored is to require regulatory commissions to expressly consider the hidden costs associated with relying upon non-utility generators in passing upon the prudence of a utility's procurement decisions. Another approach would be to require competitive solicitations to expressly weigh the extent of debt leveraging as part of project selection criteria.

**(4) Transmission Access Must Be Provided  
To Utilities And Other Wholesale Power  
Suppliers On A Non-Discriminatory Basis.**

UI is not sure that PUNCA reform legislation must address the provision of transmission services. UI believes that it is vitally important that FERC should play an active and forceful role in assuring utilities and other wholesale power suppliers access to transmission services on a non-discriminatory basis. And, while UI agrees with its utility brethren that voluntary access has worked in the past, UI also believes that in the evolving competitive market there are benefits to be gained through a more open provision of transmission services. A voluntary approach does not preclude this from occurring, but it can allow impediments to occur

that are difficult and time consuming to remedy through regulatory proceedings.

It is clear, however, that PURCA reform without provisions addressing transmission access and pricing is becoming increasingly unlikely. UI believes the following six (6) principles are particularly appropriate for the current state of the industry and should be reflected in any legislation on transmission that might be enacted.

- Voluntary access should be encouraged wherever possible, provided such a regime does not confer an undue competitive advantage to any wholesale power supplier.
- Long-term transmission services should be available to all utilities at cost.
- Short-term transmission services should be available on a non-discriminatory basis and in a fashion that does not give the transmission owner a competitive advantage.
- Firm service should have priority over non-firm service with appropriate compensation.
- The purchaser of transmission services should have an unrestricted right to resell or reassign the services.
- Greater transmission access should first be encouraged through incentives, especially where regional open access arrangements can be developed. Although the carrot is the preferred approach, the stick (through the imposition of sanctions) may have to be employed if such sanctions do not work.

In conclusion, PURCA reform, if properly pursued, could be of great benefit to the industry. However, to succeed at creating competition and increasing the supply options available to

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utilities, Title XV and the other reform proposals will have to be expanded to address a number of issues critical to creating a fair and truly competitive wholesale generation market. Absent such expansion, PUNCA reform would likely exacerbate the problems of the industry and could result in utilities and their customers becoming hostage to highly leveraged power projects and unnecessarily high electric rates. Responsibly pursued, UI will support PUNCA reform. As currently drafted, UI opposes Title XV.

THANK-YOU.

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**SUMMARY OF THE TESTIMONY OF DON D. SYKORA,  
PRESIDENT AND CHIEF OPERATING OFFICER, HOUSTON LIGHTING & POWER  
BEFORE THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS  
SUBCOMMITTEE ON SECURITIES, SEPTEMBER 17, 1991**

Houston Lighting & Power Company opposes amending the Public Utility Holding Company Act (PUHCA) because it would promote the interests of unregulated power producers at the expense of service reliability and consumer rates. HL&P has significant experience with unregulated power producers. There is more non-utility generation in HL&P's service area than anywhere else in the country — 4,800 megawatts — enough capacity to generate more electricity than was used in the entire state of Connecticut in 1989. Amending PUHCA to give unregulated generators access to the electricity market would allow them to siphon easy profits from the American people while they undermine the reliability of the U.S. electricity supply.

Further, the amendment will have a significant impact on investors, who will unwittingly assume greater risk, and on consumers who will pay higher prices for less reliable electric service. PUHCA was enacted to provide financial stability to an industry that is essential to the nation's economy. The proposed amendment will chisel out the cornerstone of that stability.

PUHCA protects America from exploitation by highly leveraged holding companies whose greed caused so much damage to both consumers and investors in the 1930's. Title XV of S.1220 eviscerates PUHCA. If adopted, this amendment would create a class of unregulated power producers dedicated solely to earning short-term profits with no statutory obligation to serve the consumer.

There is a chorus of opposition to the proposed amendment. A study published in June 1991 by the Congressional Research Service states: "Whatever else may be said about the current regulatory system, it has worked. . . . The major reason why the system has worked is because of the ingenious schemes of regulation devised at the time of the enactment of the Federal Power Act and the Public Utility Holding Company Act."

A recent economic analysis has found that "The excesses of the 1980's were not the result of debt per se, but rather that in the notorious cases, those enjoying the benefits of the debt were able to shift the attendant risks onto other parties (emphasis added)." Similarly, Joseph C. Swidler, a founding partner of the National Economic Research Association and past chairman of both the FPC and the NYFSC, warned that the impressive profitability of unregulated power producers is "a matter of juggling the financials and imposing some of their costs on the utilities and the taxpayers." He also pointed out that because of the financial structure of unregulated generators, "the Treasury loses substantial tax revenues." Amending PUHCA will give unregulated power producers a free ride on the backs of American consumers.

A public opinion poll conducted by Cambridge Reports found that three-fifths of all Americans believe that deregulation in other industries has led to higher prices, lower service quality and elimination of services — a trend they fear will be true of electric companies as well:

"... a clear plurality say electric companies aren't regulated enough. Indeed, half the population think electricity prices would rise if industry regulations were lifted, and few people see any resulting advantage in service reliability."

Reliability of service is clearly jeopardized by increased reliance on non-utility generators who have no statutory obligation to serve. This conclusion is borne out by reports in the trade press. The Gulf Coast Cogeneration Association Newsletter reported that 50% of non utility generation will change hands in the next ten years. And that's if they're still in business. Robert Sherman, the Vice Chairman of the National Independent Energy Producers (NIEP), admitted recently that "competition can go too far," and warned that non utility generators may abandon projects after signing contracts with utilities if their economic viability is threatened by "unforeseen events." One can only imagine what their definition of "unforeseen events" might be.

If PUHCA is amended as proposed, unregulated generators will reap short term profits by transferring the risk of their otherwise unbearable leverage onto utility consumers. The profits will roll in to unregulated generators because of cross subsidization, hidden financing and risk shifting. These profits will be magnified through the overuse of leverage. Moody's, Standard and Poor's, and Merrill Lynch have all published their concerns with the risks associated with reliance on unregulated generators.

The National Conference of State Legislators, composed of more than 7,300 elected officials from all 50 states, and the National Association of Regulatory Utility Commissioners, with more than 350 members, have both passed resolutions opposing restructuring the nation's electric utility industry. On the other side of the issue, not even the lobbying arm of the natural gas industry, the American Gas Association, can agree to support PUHCA amendment, despite the fervid efforts by segments of that industry, which scent easy money, to force the AGA to support it.

The proposed PUHCA amendment closely resembles the last big so called improvement in utility regulation - the Public Utility Regulatory Policies Act (PURPA). PURPA promoted the unregulated non-utility generation of electricity and required utilities to purchase electricity from these cogenerators- whether they needed it or not. PURPA has NOT worked, because this well-intended federal legislation has been manipulated in such a way as to saddle electric consumers with billions of dollars in excessive costs. How many more "improvements" can the country's ratepayers afford? This committee hardly needs to be reminded of the lessons learned from our most recent deregulation experiment - the savings and loan debacle.

The proposed PUHCA amendments will lay bare the savings of the American people to yet another wave of rapacious firms dedicated to the pursuit of short term profits. It will force utilities to transfer the wealth of their consumers to unregulated generators.

This isn't just an electric utility issue -- it's a consumer issue. That is why it is critical that the Banking Committee not relinquish its jurisdiction on this issue. This committee must protect consumers from the grave risks associated with unregulated power producers. The Banking Committee must continue in its role as the institution which balances the interests of the consumer and the investor to keep the American economy on track. It must exercise its jurisdiction over Title XV of S.1220 and delete the provisions which would amend PUHCA.

**Summary Statement of John E. Lobbis**  
**Chairman, President and Chief Executive Officer**  
**Detroit Edison Company**  
**Before the Subcommittee on Securities**  
**of the**  
**Committee on Banking, Housing and Urban Affairs**  
**United States Senate**  
**September 17, 1991**

Mr. Chairman and members of the Subcommittee, thank you for the opportunity to address you this morning.

I am John E. Lobbis, Chairman, President and Chief Executive Officer of The Detroit Edison Company

Detroit Edison is the 16th largest electric utility in the United States. It is a member of the Electric Reliability Coalition -- a group of more than 40 investor-owned utilities serving about 75 million Americans that opposes reopening the Public Utility Holding Company Act -- or PUHCA -- to create a new category of Exempt Wholesale Generators of electricity that would be exempted from the consumer and investor protection provisions of the Act.

My purpose here today is to request that this Subcommittee recommend that the Banking Committee assert jurisdiction over Title XV of S. 1220 for the following reasons:

First, the Banking Committee has always exercised jurisdiction over this legislation. Under the watchful eye of the Banking Committee, PUHCA has worked well in protecting the public by eliminating abuses that had been common in the industry before the Act was passed in 1935. Some suggest the dramatic reduction in such abuses is evidence that the Act is no longer needed. I suggest to you that, instead, it is evidence that the Act is working...and its protections are needed.

Second, the last significant exemption made to PUHCA was made in 1978, when the Public Utilities Regulatory Policies Act -- known as PURPA -- created a relatively narrow exemption for Qualified Facilities in line with an energy policy of encouraging alternative and renewable fuel sources. The Banking Committee asserted very clear jurisdiction at that time. The exemption now under consideration is considerably broader -- in fact, it is wide open. It is difficult to understand the Committee abtaining from jurisdiction at this time.

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Third, EWGs, like Independent Power Producers generally, use leverage extensively -- typically 80% - 90% of capitalization, vs. about 50% for utilities. Because the cost of equity is higher than debt and debt receives favorable tax treatment, EWGs are given a price advantage not available to utilities. Moreover, the high level of debt of an EWG would be imputed by banks, rating agencies and financial markets to the utility that contracts with the EWG for power, thereby weakening the utility's financial structure.

Electric utilities are the most capital-intensive of all industries, with \$2 invested for every \$1 of annual revenue. By comparison, the natural gas industry has 80 cents invested per dollar of annual revenue and the steel industry has 45 cents per dollar of annual revenue.

In such a capital-intensive industry, use of leverage has an especially pronounced effect.

Fourth, electric utilities are long-term in focus. Their obligation to serve, combined with their capital intensiveness and their 10-15 year planning cycles, mandates that they maintain the financial strength to weather economic cycles.

Fifth, please consider what you want from utilities 10 or 15 years from now. If additional environmental protection and improvement are part of that agenda, utilities must be financially strong to deliver on it.

And finally, Title 15 purports to solve a problem that doesn't exist. Future generating capacity can be adequately provided under current laws. Studies in 1989 and 1991 by the Office of Technology Assessment and Congressional Research Service, respectively, confirm this view.

Title 15 solves nothing and yet will create a situation of excessive debt in one of the few remaining well-capitalized industries in this country -- a problem certainly within the purview of this Committee.

I urge you to assert jurisdiction so we can have a complete discussion on this topic and so that, once again, this Committee will guide changes to PURCA under its watchful eye.

STATEMENT OF JOHN E. LOBBIA  
CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER  
DETROIT EDISON COMPANY  
BEFORE THE  
SUBCOMMITTEE ON SECURITIES  
OF THE  
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS  
UNITED STATES SENATE  
SEPTEMBER 17, 1991

Mr. Chairman and members of the Subcommittee. I am John E. Lobbia, Chairman, President and Chief Executive Officer of The Detroit Edison Company. Detroit Edison provides electricity to nearly 2 million residential and business customers, including many of our nation's most vital industries, in a 7,600-square-mile service area in southeastern Michigan. We are the largest electric utility in the State of Michigan and the 16th largest in the United States. We have been actively engaged in the electric business in this area since 1903.

I appreciate the invitation of the Subcommittee to document why, in the public interest, this Subcommittee should recommend that the Banking Committee formally assert its jurisdiction with respect to Title XV of S. 1220. As reported by the Senate's Committee on Energy and Natural Resources, Title XV would amend the Public Utility Holding Company Act of 1935, which is commonly referred to as "PUHCA" and is administered, subject to your supervision, by the Securities and Exchange Commission. Specifically, Title XV would provide a blanket exemption from the investor and consumer protection provisions of PUHCA for holding companies that own wholesale electric power generating facilities in more than one state.

Detroit Edison is an active member of the Electric Reliability Coalition, a group of more than 40 investor-owned, state regulated public utilities, each of which is legally obligated to -- and does in fact -- provide all consumers in its service area with electricity in the most reliable manner possible and at rates regulated by state authorities in the public interest. Detroit Edison supports the Electric Reliability Coalition in its opposition to reopening PUHCA for the benefit of so-called exempt wholesale generators ("EWGs") and associates itself with the statement presented to this Subcommittee by Sherwood H. Smith, Jr., the Coalition's Chairman and the Chairman and President of Carolina Power & Light Company.

In my testimony, Mr. Chairman, I want to focus specifically on one issue; namely, why the Senate Banking Committee should -- in terms of both Committee precedent and national economic policy -- formally assert jurisdiction over the proposed amendments to PUHCA.

PUHCA provides a regulatory framework which has worked well to serve the public interest. Within the last several decades we have removed the regulatory framework in other industries with mixed results and in some cases at substantial cost to taxpayers and consumers. This situation is potentially no different for the electric industry. You've heard the arguments promising sure fixes. All too often, the sure fixes caused more problems than they were purported to solve.

I believe that:

- Title XV of S.1220 is special interest legislation. It will permit the creation of scores of multistats, unregulated generating companies.
- State utility commissions, under least-cost pressures, will require regulated utilities to establish take-or-pay arrangements with these unregulated companies.

- These long-term contracts will then be used to secure the highly leveraged, non-recourse financing needed to construct the plants.
- Financial institutions will treat such non-recourse obligations as utility debt, which will negatively impact the utility's stocks, bonds and capitalization.
- This will force utilities and their customers to rely for future electric supply resources upon the construction of power plants by single-purpose, thinly-capitalized unregulated multi-state EWGs that have no legal obligation to serve the public interest.
- This, I submit, is legislation that is focused on the short term, while the economic and social progress of our nation demands utilities that will have financial strength to serve for the long term.

PURCA was enacted by Congress for the specific purpose of preventing precisely what Title XV will permit.

As I indicated, and shall explain in greater detail in a moment, the beneficiaries of this legislation will seek to use highly leveraged capital structures to exploit our federal tax laws and tap into the equity base of utilities, one of the few equity bases that survived the 1980s. Under this scheme, the



utilities would continue to bear the principal risks of owning and operating electric power production and distribution facilities, including those facilities owned by independent non-utility operators. This is a form of the "no risk capitalism" that characterized the 1980s. Indeed, with its disconnection of risk and reward, the proposed PUHCA changes bear an almost disquieting parallel to the attempts to deregulate financial institutions.

We are starting down this very same road here and our respective constituencies, be they ratepayers or voters or taxpayers, will simply not understand why we -- the nation's utilities and the Senate Committee with the greatest financial expertise and the clearest jurisdiction -- failed to take a hard look and ask the difficult questions before the fact. Our various constituencies -- yours and ours -- expect us to learn from the past. They will properly hold us accountable if, without considering the consequences, we simply repeat the mantra of "deregulation" over and over and over again. I respectfully request that, on the basis of the evidence I now want to present to you, this committee assert its jurisdiction and take that hard look and ask those difficult questions before the Congress acts.

Our analysis must begin with PUHCA itself. As this Subcommittee is well aware, PUHCA was enacted in 1935 in response to the financial abuses of multistate electric utility holding companies. These unregulated entities were so heavily leveraged

that when the economy worsened they were unable to meet their obligations, to the detriment not only of themselves but also of their customers and investors. As a result, when Congress enacted FURCA it prohibited some of the kinds of reckless financial behavior that gave rise to this situation.

Under FURCA, any company that owns more than a 10 percent interest in a company that generates, transmits or distributes electric energy for sale must register with, and be subject to regulation by, the SEC unless the holding company system qualifies for at least one of five available exemptions. The most important of these is the exemption for companies with operations exclusively within a single State. As indicated earlier, one of the dominant pre-FURCA characteristics of such multistate holding companies was the use of inordinate amounts of debt. Consequently, multistate utility holding companies that are regulated under FURCA are subject to limitations on the amount of leverage they can employ. Thus, the key points for our purposes here, Mr. Chairman, are that FURCA was enacted consciously to protect consumers, as well as investors in securities, and that Congress focused specifically on the risks that excessive leverage presented to both groups. Accordingly, as I will explain in this testimony, protecting consumers and investors from the risks of excessive leverage must be the cornerstone of any serious debate over the merits of the proposed FURCA amendments.

Proponents of amending PUHCA see it otherwise. They claim that times have changed. They argue that PUHCA now stands as little more than an anachronistic barrier to the development of enterprises that, operating on an unrestricted multistate basis, would simply provide an alternative to utilities that wished to purchase electricity for resale rather than construct their own generating plants. Having convinced a majority of the Senate Energy Committee that PUHCA is simply an unnecessary regulatory barrier to EWGs, proponents of amending PUHCA would prefer that you not assert jurisdiction over this legislation. In fact, however, such a "hands-off" policy by the Banking Committee is virtually unprecedented. Despite the almost seductive appeal of legislation that is characterized by its supporters as merely removing an outdated regulatory impediment to competition in the generation of electric power, the involvement of the Banking Committee on a formal basis is necessary to assure a proper examination of the complex financial issues that are at the very heart of the debate over PUHCA reform.

Failure of the Banking Committee to assert jurisdiction over Title XV of S. 1220 would be contrary to the Committee's own well settled practices. Under Senate Rule XXV.1(d)(1), the Banking Committee has historically exercised, without challenge, jurisdiction over the SEC and the statutes that collectively comprise the federal securities laws. The Subcommittee should recommend that the Banking Committee assert jurisdiction here because the proposed PUHCA amendments would substantially curtail

the SEC's regulatory authority. The Committee participated in the initial enactment of PUHCA in 1935 and appears to have played a direct role in virtually every other substantive amendment to PUHCA since then. As recently as last year, for example, the Banking Committee exercised jurisdiction over the Gas Related Activities Act of 1990 (P.L. 101-572), which clarified the application of PUHCA's "functional relationship" test to natural gas utility companies. Similarly, the Banking Committee exercised jurisdiction with respect to a 1985 PUHCA amendment relating to the treatment of cogeneration by gas utility companies (P.L. 99-186); the Securities and Exchange Commission Act of 1987 (P.L. 100-181), relating to certain technical amendments; and the Securities Acts Amendments of 1975 (P.L. 94-29), relating to penalties for violations of PUHCA.

Most significantly, however, the Banking Committee exercised jurisdiction in connection with the Public Utilities Regulatory Policies Act of 1978 (P.L. 95-617). This legislation -- commonly referred to as PURPA -- exempted from PUHCA a new class of energy producers ("Qualified Facilities") and required that their output be purchased by public utilities. The current proposed amendments to PUHCA are equivalent in principle to those contained in PURPA in that they would create a new class of electricity generators and exempt that class from PUHCA. Indeed, the current proposed amendments will have an even greater impact than PURPA. One of the main purposes of the proposed amendments is to foster a greater number of independent power facilities

then assertedly would be built under the PURPA exemption, which is limited to small power producers and cogenerators. The current PUHCA proposals would thus increase substantially the amount of the nation's electric generating capacity that would be owned by unregulated multistate holding companies. Moreover, under PURPA, no electric utility is permitted to own more than 50 percent of a "Qualified Facility". There would be no such ownership limitation with respect to EWGs. Thus, the Banking Committee, on the precedent of PURPA alone, should assert jurisdiction with respect to Title XV of S. 1220. Indeed, given the financial risks to consumers, taxpayers and small investors that this proposed experiment in so-called deregulation presents, it is difficult to fathom how these precedents could be so lightly cast aside.

As I have stated earlier, Mr. Chairman, formal referral of the proposed PUHCA amendments to the Banking Committee is important not simply as a matter of precedent. Quite properly, the acknowledged expertise of the Banking Committee with respect to complex financial matters is not duplicated within the Energy Committee, which has a different programmatic focus. The Banking Committee's financial expertise should be brought to bear here because the real issues under Title XV of S. 1220 are financial issues and not energy policy concerns. Let me explain why.

At the outset, this committee should recognize that the driving force behind the push to exempt EWGs from PUHCA is the

desire of project developers to build highly leveraged facilities using separate corporations for each project. This results in individual projects backed with minimal capital investment, with none of the parent company's assets exposed in the event of project failure. The use of such "non-recourse" financing raises the question of why those who are promoting EWGs are unwilling to back these projects with the full faith and credit of their corporations.

Of paramount importance is the fact that EWGs will not compete with regulated utilities on the basis of inherently superior technology, management or operating skills that will increase economic efficiencies. Rather, as the material submitted in connection with this testimony demonstrates, EWGs will "compete" by using extraordinary levels of non-recourse debt that approach 90 percent or more of total project cost. In contrast, as a result of regulatory requirements and the constraints imposed by the capital markets, the capital structure of a regulated utility or a registered holding company typically consists of approximately 50 percent equity and 50 percent debt.

As a result of the federal tax bias in favor of debt financing -- i.e., interest on debt is tax deductible while dividends on equity are not deductible -- the more highly leveraged EWGs will have a substantial cost-of-capital advantage. If this artificially induced cost-of-capital advantage can be maintained, it will enable EWGs consistently to underbid

utilities for the construction of new generating plants while at the same time paying their equity holders a higher rate of return than that permitted for regulated utilities. In this case, what purports to be "deregulation", upon closer scrutiny, amounts, rather, to reregulation for the benefit of a select few.

Ordinarily the tax-induced cost-of-capital advantage resulting from excessive leverage could not be maintained. For most businesses, providers of equity and lenders would demand greater financial returns to compensate them for the added risks of higher leverage. In turn, this additional "compensation" to the providers of capital would offset, in most cases, the tax advantages that would otherwise result from excessive leverage.

In the case of EWGs, however, the factors that could normally be expected to apply to businesses would not apply. Permit me to explain why.

Normally, electric power generating plants are subject to the financial market's rule against piling dollar of debt upon dollar of debt. It has been repeatedly pointed out, without challenge, that there is a substantial amount of risk associated with utility plant investment. Such plants require a large capital investment, have a single purpose, and cannot be moved. Moreover, past history indicates that fuel costs are unpredictable. Finally, there can be no certainty as to whether the projected consumer demand, necessary to support the plant,

will be sustained over the useful life of the plant. Given these risk factors, prospective lenders to highly leveraged EWGs would ordinarily demand high interest rates -- perhaps approaching "junk bond" levels -- in order to compensate them not only for the time value of the money they provide, but also for the greater risk that such a high degree of leverage entails. In short, a highly leveraged EWG should not be able, absent some special factor, to maintain any cost-of-capital advantage over a regulated utility.

But -- and here is the key, Mr. Chairman -- EWGs do expect to have just such a "special factor" that will enable them to avoid the high interest rates their high degree of leverage normally would require. By exploiting this special factor, EWGs will preserve the tax-induced cost-of-capital advantages of high leverage. That is because the utilities that purchase power from EWGs will be effectively required to assume, through long-term contracts, many of the risks associated with operation of the EWG's power plant. Under these contracts, capacity charges, mandatory power purchases, fuel adjustment clauses and similar provisions will assure that the EWG is guaranteed a stream of income from the utility sufficient to assure lenders that the EWG will be able to repay its debts. Moreover, the risk of reduced consumer demand would remain with the utility as well. The utility would not likely be compensated by the EWG for assuming



such risks because any such compensation would in effect shift the risk back to the EWG and subject it to interest rates that would jeopardize its viability.

In short, the competitive viability that an EWG may have will in all likelihood be attributable simply to its use of a highly leveraged capital structure and the ability to shift -- without compensation -- the risks and costs of such a skewed capital structure to the regulated utility and its customers. This is not competition or capitalism, Mr. Chairman. There is no discipline of the marketplace in such a case that will substitute for the restraints of PUHCA that are to be washed away in the name of deregulation. Without either regulatory restraints or marketplace discipline, EWGs will profit and leave consumers and taxpayers with the bills to pay, just as did the S&L owners, the LBO sponsors and the other high-leverage no-risk artists of the 1980s.

For the reasons I have summarized, if PUHCA is amended in the manner contemplated by Title XV of S. 1220, EWGs operating on a multistate basis could well lead to the creation of the very same risks to consumers that contributed so significantly to the decision of Congress to enact PUHCA in the first instance. The fact that we have not recently seen the kinds of widespread abuses that were rampant before PUHCA was enacted is not evidence

that the PUHCA protections are not needed. Rather, it is evidence that PUHCA protections are still working and should be retained.

For these reasons, Mr. Chairman, I believe that it is imperative, in the public interest, for this Subcommittee to urge the Banking Committee to assert formal jurisdiction over any amendments to PUHCA. The issues the Banking Committee should address are neither speculative nor tangential to the PUHCA debate. They are fundamental and go to the very heart of the wisdom of amending PUHCA.

If this proposed legislation goes forward, the substantial levels of equity now invested by utilities in electric generating plants to provide essential electric service to consumers, business and industry will necessarily be reduced to the extent incremental or replacement capacity is built by highly leveraged EWGs. Is this a concern to the Banking Committee? It must be. Our utilities are one of the very few industries that survived the 1980s with an equity base more or less still in place and there is no compelling reason now to permit others to divert utility equity to their own purposes.

Further, regulated utilities will have their cost of capital for their own projects increased if they rely to any substantial extent on power purchases from EWGs. Private sector rating agencies such as Moody's have already made it plain that

utilities with substantial EWG contracts may have the project indebtedness of the EWG attributed to them. In such a case, the imputed debt would reduce the equity-to-debt ratio the utility would be deemed to have when it seeks to finance its own new projects. Faced with such a situation, the utility would be required either to raise new equity at a higher cost than debt under current tax laws or pay an interest rate based on a higher risk premium for new debt, or both. Thus, to the extent the utility is required to incur costs to offset the effect of EWG project indebtedness, those costs are passed through to consumers and reduce the "savings" promised in the first instance by EWG sponsors. There is no free lunch for consumers. Rather, they end up paying the bill for the EWGs. This financial slight-of-hand should also be of concern to the Banking Committee.

A third issue that must be considered involves EWG contracts which shift the demand and operational risks of the EWG facility to a utility without any compensation to the utility. Additionally, the EWG's plant will not be included in the utility's rate base and the utility thus will not be entitled to earn a rate of return on the plant that would compensate it for those risks. In short, the risk the EWG can avoid through its utility contract in order to preserve its financial integrity at 90 percent debt levels will be borne by a utility that is being "decapitalized" through rate base reductions resulting from the growth of excessively leveraged EWGs. This too should be of vital concern to the Banking Committee.

Mr. Chairman, these are only illustrations of the complex financial issues that are at the heart of the debate over PUHCA amendment. There are many other issues that require the consideration of this Subcommittee. Among these are:

- the reduced ability of utilities to meet the increasing environmental and other external obligations that our social concerns and sensitivities are imposing on them if their capital base is depleted by the growth of highly leveraged EWGs. The most recent round of Clean Air Amendments alone are mandating expenditures in excess of a billion dollars for individual utilities. As these individual utilities' financial strength is impaired, so too is their ability to meet these obligations;
- the adverse effect on utility financial strength resulting from a loss of access to the residual value of EWG facilities;
- the adverse effect on residential and small business consumers which would result if PUHCA amendment were to be coupled with transmission bypass legislation which would, in turn, foster the loss of large industrial base loads to EWGs.

For these reasons, Mr. Chairman, this Subcommittee must, in the public interest, urge the Banking Committee to assert formal jurisdiction over the subject matter of Title XV of S. 1220. PUHCA is not an anachronism that has outlived its usefulness. It serves the very important purpose of continuing to protect consumers and investors. Amendments to PUHCA should receive, as they have received in the past, strict scrutiny from the Banking Committee. This, in my view, is the only way we can be sure that we do not suddenly realize one day in the future that, to our great dismay, we have inadvertently recreated the worst parts of the past.

At the very least, Mr. Chairman, we owe it to our respective constituencies to take a serious look at these issues before we enact legislation. We should not act in the blind hope that this experiment in deregulation will work. Mr. Chairman, what we are being asked to do is not to solve a problem, but to scrap a system that works, and works well. As the Congressional Research Service recently concluded:

Whatever else may be said about the current regulatory system, it has worked. The Nation has enjoyed many decades of available electricity at prices well within the norm for [sic] industrialized world. And, there is every indication that the system will continue to respond to changes in technology, utility structure and consumer needs. The major reason why the system has worked is because of the ingenious scheme of regulation devised at the time of enactment of the Federal Power Act and the Public Utility Holding Company Act. That scheme was forged a half-century ago in an effort to provide a flexible balance between Federal and State regulation for the purpose of assuring competent regulation and reliability of service.

**"Electricity: A New Regulatory Order?", Report of the Congressional Research Service for the House Committee on Energy and Commerce at page 363 (1991). (Emphasis added.)**

**There is no great urgency that I can see that suggests the federal government should dismantle this system that has worked -- and continues to work so well.**

September 17, 1991

**SUMMARY OF WRITTEN TESTIMONY OF SHERWOOD H. SMITH, JR.  
BEFORE THE SENATE SECURITIES SUBCOMMITTEE**

The Electric Reliability Coalition's 40+ members are a diverse group of regulated, investor-owned electric utilities. ERC members are committed to preserving (1) the system of vertically integrated electric utilities, subject to state regulation of rates and services for the protection of electricity consumers, and (2) the complex system of voluntary and mutually beneficial transmission services. These two factors have enabled regulated utilities to maintain highly reliable service at lowest possible cost.

Title XV of S. 1220 would be by far the most significant alteration of the Public Utility Holding Company Act in 55 years. The Banking Committee must assert jurisdiction over this legislation to consider its impact on consumers and investors and on the financial stability of the electric utility industry. Title XV would encourage pyramidal holding company ownership of massive investments in the next generation of power plants, operating without SEC oversight and beyond state regulatory jurisdiction. PUCHA "reform" is a strategy for earning returns on new investments greater than would be permitted by state regulators, which can only come out of ratepayers' pockets.

New holding companies will present several serious public interest problems that led to PUHCA's enactment. First, EWGs will be highly leveraged, utilizing far higher levels of debt (80-90%) than utilities are allowed to use. Second, EWGs will not have to disclose inter-affiliate and other transactions, setting the stage for unnecessary mark-ups in costs. Third, EWGs' profits will be unregulated.

In contrast to the approximately 50-50 debt-equity ratio typical of regulated utilities, EWGs and their holding companies will be debt-ridden and financially unstable. Highly leveraged EWGs will have a significant, tax-induced artificial advantage over traditional utilities and will use their cost-of-capital advantage to shift the

most significant business risks of electric power production to utilities and their consumers. Using high-debt financing, ENG's will either offer excessive equity rates of return or be highly inefficient, or both, yet still appear to be price-"competitive" with utilities.

State regulators may fail to consider all indirect costs to a utility of relying on ENG power. Utilities may, as a practical matter, be unable to opt for utility-provided rate-base alternatives that would be less costly over the long term. Electric utilities will likely end up paying more to buy power than if they had produced it themselves. The consequence would be higher rates to consumers.

The Subcommittee should closely examine the long-term effects of unregulated ownership, financed almost solely with debt and subject to no duty of public service. In other industries, generally, the excessive use of debt has caused major problems. The failure of electric generation companies could have even more serious public consequences.

Title XV also would resurrect the potential for inflation of electric rates through affiliate transactions within unregulated holding company structures. Even with modern regulatory tools, State commissions have not found it easy to effectively regulate transactions between jurisdictional utilities and unregulated affiliates. According to Commissioner Ronald Russell of the Michigan POC:

With the [PUBCA] exemption, corporate structure and transactions between corporate affiliates, can be manipulated to embrace the concept of competitive generation while ensuring that all competitive advantages reside with holding company affiliates.

Title XV would profoundly change one of the cornerstones of the federal system of consumer and investor protection, altering a legal framework within which the electric utility industry has performed well. Two of the cardinal principles of PUBCA -- full disclosure of electric utility costs and profits and protection of the consumer from



financial abuses under cover of a holding company structure -- would be largely lost under Title XV.

The Subcommittee -- and ultimately the full Committee -- should consider carefully the conclusions of the Congressional Research Service. According to CRS:

Whatever else may be said about the current regulatory system, it has worked. The Nation has enjoyed many decades of available electricity at prices well within the norm for industrialized world. And, there is every indication that the system will continue to respond to changes in technology, utility structure, and consumer needs.

CRS, echoing earlier findings by the Office of Technology Assessment, recommended that proponents of PUECA exemptions and other basic changes to industry structure be required to "bear the burden of proof" that such restructuring somehow will result in even better performance by the electric power industry. In light of these uncertainties, and the potential for yet another disastrous deregulatory experiment, we believe that the Banking Committee should not abdicate its historic responsibilities to fully consider Title XV of S. 1220 and oversee this and any similar proposal to create loopholes in the the Holding Company Act.

September 17, 1991

BEFORE THE SECURITIES SUBCOMMITTEE  
OF THE  
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

TESTIMONY OF SHERWOOD H. SMITH, JR.

Chairman and President,  
Carolina Power & Light Company  
and  
Chairman, Electric Reliability Coalition

This testimony is submitted on behalf of Carolina Power & Light Company and the Electric Reliability Coalition (ERC), of which I serve as Chairman. Carolina Power & Light Company is an investor-owned electric utility serving about 960,000 customers in a 30,000 square-mile service territory in North and South Carolina. Our system has a generating capacity of about 9,700 megawatts. We use coal and nuclear energy as our principal sources of fuel, operating 19 coal-fired generating units and four nuclear units, as well as about 40 smaller hydroelectric, combustion turbine, and waste heat units. Our company was a pioneer in the development and use of nuclear power, having built the first nuclear units in both North and South Carolina.

In my work, I have had the opportunity to serve on a number of industry boards, including Director and past Chairman of the Edison Electric Institute (EEI); the North American Electric Reliability Council (NERC); the Southeastern Electric Reliability Council (SERC) of which I have been Chairman; as a Director of the Institute of Nuclear Power Operations (INPO); and as a Director and past Chairman of the American Nuclear Energy Council

(ANEC). I was a principal witness and industry coordinator during the lengthy hearings on the Public Utility Regulatory Policies Act (PURPA) in 1977 and 1978. In 1989 and again this year I testified before the Senate Energy and Natural Resources Committee on proposals for amendment of the Public Utility Holding Company Act. My experience, I believe, has provided me with an understanding of the financial and other issues arising out of proposals, such as Title XV of S. 1220, to restructure the electric utility industry.

The Electric Reliability Coalition comprises over 40 investor-owned regulated electric utility companies. ERC is a diverse group of large and small utilities located throughout the country. Some of our members are organized as single companies; others are exempt or registered holding companies. All ERC members share a commitment to preserving the existing system of vertically integrated electric utilities, regulated by the states in the public interest generally and for the protection of electricity consumers specifically. We are equally committed to preserving the increasingly complex system of voluntary and mutually beneficial transmission services. Together, these two factors have enabled regulated utilities to maintain highly reliable service at lowest possible cost.

I urge this Subcommittee to recommend that the Banking Committee assert jurisdiction over Title XV of S. 1220. If the Committee does not assert formal jurisdiction over Title XV, we urge members of the Committee to oppose Title XV, should it

otherwise reach the Senate floor, as not in the public interest.

The bill would amend the Public Utility Holding Company Act to create a new class of "Exempt Wholesale Generators" (EWGs), free from oversight by the Securities and Exchange Commission. In the misleading name of "reform," Title XV would encourage proliferation of holding companies to own and control the next generation of power plants. The legislation would tend to separate the production of substantial amounts of electric power from its transmission and distribution. This would allow massive amounts of new electric power generating capacity to be owned and controlled by unregulated holding company structures. These holding company structures would operate outside the regulatory oversight of the SEC and beyond the regulatory jurisdiction of the states.

Proponents of the legislation hope, purely and simply, to reap larger (and undisclosed) returns on their investments in these new plants than would be permitted by state regulators were the new facilities instead built by electric utilities under regulation. In this way, EWG developers hope to take advantage of the nation's need for new generating capacity in coming years. Unfortunately, the higher returns -- the "upside" of unregulated profit -- can come from no source other than the pockets of electricity consumers.

These new holding companies present several serious public interest problems that led Congress to enact PUHCA in 1935.

First, EWGs will be highly leveraged, utilizing far higher levels of debt than are permitted to utilities generally or to registered holding companies under current SEC policies. Second, these nonregulated operators will not be subject to public disclosure requirements of inter-affiliate and other transactions, setting the stage for unnecessary mark-ups in costs. Third, EWGs' rates for wholesale power will not be regulated by the states, which would otherwise control the profits obtained by franchised utilities from new generation investments.

PUHCA amendment is a prescription for the creation of a debt-ridden and unstable electric generating industry. EWG advocates are frank to admit that they plan to use 90% or more debt to build such projects, in contrast to the approximately 50-50 debt-equity ratio that a regulated utility would use to finance the same new capacity. EWG developers want to commit as little corporate capital as possible to each project, and will use separate subsidiary corporations for each generating project, thereby shielding the assets of holding company parents and affiliates. This is precisely why they seek exemption from PUHCA under Title XV.

Such high levels of debt are not normal or sustainable in most industries, much less in the highly capital intensive electric utility industry. But these highly leveraged EWGs will have a significant, tax-induced, artificial advantage over traditional utilities. Because of the tax advantages of debt,

ENGs may appear to price power in the short term at lower cost than utility-built alternatives. As a result, ENGs will demand -- and probably get -- long-term and largely unconditional purchase commitments from regulated retail utilities. In reality, ENGs will use their cost-of-capital advantage to shift the most significant business risks of electric power production to franchised electric utilities who buy power from them, which risk in turn will fall upon electric consumers.

Advocates of Title XV insist that it would merely create an "option" for utilities to buy power from these new, deregulated ENGs. But the financial advantage to an ENG using 90% debt financing is so great that such a project probably could price electricity 5-10 percent lower than the direct cost to a utility of building and operating equivalent capacity. (The price difference between power generated by gas-fired ENGs and new coal or nuclear baseload utility plant could be even greater.) As explained in the economic study submitted with this testimony,<sup>1/</sup> ENGs could either offer excessive and unjustified equity rates of return or be highly inefficient, or both, and still appear to be price competitive with utilities.

ENG power, while apparently less costly in the short term than utility-owned capacity, would impose significant indirect costs on a purchasing utility, and thus on the utilities'

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<sup>1/</sup> D.G. Raboy, Risk Shifting and Its Consequences in the Electric Power Industry (prepared for the Electric Reliability Coalition: May 29, 1991).

purchasing utilities are willing or involuntary buyers. Electricity consumers will, in turn, likely pay more for reliable electric service.

The promised benefits and efficiencies of PURCA "reform" and resulting "competition" between highly leveraged EWGs and regulated utilities in power production are illusory. Advocates of EWGs say that, with ownership and control of new facilities by unregulated holding companies, significant risks can be shifted from purchasing utilities and assumed by independent power producers. This is not the case, however.

The risks faced by a utility when it builds new generation are: (1) risk that projected demand and need for power will not materialize; (2) risk that construction will be interrupted and delayed or otherwise take longer than planned; (3) risk that construction costs will exceed projected levels; (4) risk of operational inefficiencies; (5) risk that fuel costs will exceed projections; and (6) the overarching risk that, under future hoc "prudency review" or the "used and useful" doctrine, state regulators will not allow the utility to recover construction costs which it has financed. Traditionally, these risks have been shared by utility ratepayers and utility stockholders under rules set by state regulators.

EWG advocates have publicly stated that project developers will not assume some of the most significant risks, i.e., the risk that, due to unforeseen changes in load growth, newly constructed capacity may turn out to be unneeded, that due to

"force majeure" construction will be more costly or delayed, and the risk that fuel prices may rise to higher levels. Indeed, highly leveraged project financing, as contemplated by EWG advocates, could be impossible if EWG developers were to retain significant risks for their undercapitalized projects. Instead, EWG advocates have testified that utilities should sign long-term contracts obligating themselves to pay for the new capacity, "regardless of market demand and regardless of fuel costs." See, e.g., Senate Energy and Natural Resources Committee, Transcript of Hearing on Amendment No. 267 to S. 406, The Competitive Wholesale Electric Generation Act of 1989, November 16, 1989, at 77, 1. 2-7.

States will not relieve utilities of the public obligation to serve consumers simply because they are relying on EWGs for their supplies. However, this means that these utilities will remain de facto guarantors of even the risks purportedly assumed by project developers. Significant reallocation of risk to outside nonregulated ventures, leading to real savings for consumers, appears inconsistent with the legal environment in which franchised utilities must operate.

The Subcommittee should consider carefully the long-term effects of having more and more electric generation in this country dependent upon unregulated ownership, financed almost solely with debt, and subject to no duty of public service. In other industries, generally, the excessive uses of leveraged buyouts financed by high levels of debt have caused major



electric consumers. These include the cost of increased reserve margins and redundancy in supply sources to insure against EWG failure and default, and increased costs associated with EWG power that is not readily dispatchable or which results in excessive dependency on any given fuel.

State regulators, especially if focused on the short term, may not recognize and account for all of the indirect costs to a utility associated with reliance on purchased power. Political considerations, varying from time to time, such as ratepayer interest in "apparently lower cost" EWG power, or environmental opposition to coal or nuclear power, may preclude the regulators from accurately evaluating the costs of EWG power. A utility may, as a practical matter, be unable to avail itself of utility-provided, rate-base alternatives which would be less costly over the long term.

Over time, regulated electric utilities could suffer from severe underinvestment in favor of unregulated EWG construction. More and more generating assets could move beyond state regulators' reach, and into pyramidal ownership structures over which the SEC no longer has any control. We foresee that, in this "brave new world" of deregulated electricity production, electric utilities over time will be likely to end up paying more to buy power than if they had produced it themselves. The consequence would be higher rates to consumers. This is likely to be the case regardless of whether EWGs are, or are not, affiliated with purchasing utilities, and regardless of whether

problems. The failure of electric generation companies could have even more serious public consequences.<sup>2/</sup>

Another abuse which Title XV would resurrect is the potential for inflation of electric rates through inter-company transactions within unregulated holding company structures, i.e., sales of power at inflated costs or the diversion of assets or revenues from retail utilities to unregulated affiliates. Even with modern regulatory tools not yet developed in 1935, State commissions have not found it easy to effectively regulate transactions between jurisdictional utilities and their affiliates. Commissioner Ronald Russell of the Michigan Public Service Commission has described in clear and strong terms that State's difficulties in regulating transactions between Consumers Power Corporation and some of the Qualifying Facilities and other affiliates within the 40-company CMS Energy Corporation holding

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<sup>2/</sup> Title XV of S. 1220, as reported by the Energy and Natural Resources Committee, includes a number of provisions intended to address some of the issues I have raised. For example, Section 15107 directs state public utility commissions to consider whether to adopt a standard for electric utilities under their jurisdiction that propose to purchase power from EWGs. Among other things, under this standard the state regulatory authority would evaluate the effects on a purchasing utility's cost of capital and consider whether the EWG's use of capital structures employing less than 35% equity would give it an unfair advantage over regulated utilities. Unfortunately, this provision is not required and is merely voluntary -- a state utility commission could lawfully decline to adopt any of these factors in its procedures for approving utility-EWG transactions. The Banking Committee, we believe, must consider the adequacy of this and other provisions of Title XV before a gaping exemption is opened up in the 1935 Act.

company structure. See "Who Needs PUHCA?," presented to the American Bar Association Section of Natural Resources, Energy, and Environmental Law (March 8, 1991).

Commissioner Russell's remarks, a copy of which are submitted with this testimony, raise questions about the ability of state commissions effectively to protect the public interest and to police cross-subsidization through unregulated transactions within EWG holding company structures. He characterizes the non-arms' length sale of power by one CMS generating affiliate, Midland Cogeneration Venture, to its utility affiliate, Consumers Power, as being "to the detriment of both the ratepayers and the non-affiliated cogenerators who hoped to sell power to the utility." He also notes the unprecedented volume of complex litigation spawned by, among other things, CMS affiliates' challenges to the State commission's jurisdiction. Commissioner Russell counsels against the deregulation under PUHCA of holding company ownership of generating assets in the strongest possible terms:

With the [PUHCA] exemption, corporate structure, and transactions between corporate affiliates, can be manipulated to embrace the concept of competitive generation while ensuring that all competitive advantages reside with holding company affiliates.

The Subcommittee must recognize that Title XV would profoundly change one of the cornerstones of the federal system of consumer and investor protection, altering a legal framework within which the electric utility industry has turned in an outstanding performance. Some historical perspective is in

order. The origins of today's modern economic regulatory system can be traced to the Federal Power Act of 1935, to PUHCA, and to various state laws of similar vintage. The Federal Power Act established a national policy to assure "an abundant supply of electricity throughout the United States" with economy and regard for the environment. A regulatory system was developed which eliminated uneconomic and wasteful duplication of facilities and channeled competition into an orderly process of franchised utilities responsible for providing service to all within certain geographic areas and subject to regulation of pricing based upon reasonable recovery of the costs of such service.

At the same time, the Holding Company Act established fundamental principles of utility ownership, control and operation designed to protect both consumers and investors from the financial consequences of undercapitalized, pyramidal ownership like that which characterized the unregulated system prior to 1935. According to the Federal Trade Commission, in a report that was a major impetus to Congressional action, utility holding company structures were unsound and "'frequently a menace to the investor or the consumer or both.'" FTC, Utility Corporation, Senate Document No. 92, 70th Cong., 1st Sess. (1928) (quoted in Congressional Research Service, "Electricity: A New Regulatory Order?," House Energy and Commerce Committee Print No. 102-P, 102d Cong., 1st Sess., at CRS-167 (1991)). Two of the cardinal principles of PUHCA were (1) full disclosure of electric utility costs and profits and (2) protection of the consumer from

financial abuses under cover of a holding company structure.

There followed a period of remarkable growth in electric output and a sharp decline in the real price of electricity. Despite some intervening traumatic events for the industry, we continue to have adequate supplies of electric power in this country at reasonable costs. In fact, the real price of electricity in many places has been declining over recent years and some regions have large reserve margins.

Thus, I believe that by any standard, over many years, the investor-owned electric utility industry has done an outstanding job in meeting the needs of electric consumers in this country by providing them with adequate, reliable and reasonably priced electricity. This has been accomplished by a large and incredibly complex system of vertically integrated utilities, with rates of return on all investments, including generation, transmission and distribution facilities, regulated by state commissions. Companies that opted to set up holding company structures to own facilities in multiple states were subject to SEC scrutiny of their securities and transactions, and have been permitted only to operate "integrated systems" in adjacent states. This fully integrated, and regulated, system produces economies and reliability that cannot be guaranteed under other forms of industry structure, especially one characterized by unregulated, geographically dispersed holding companies.

The experience in other deregulated industries, if applied to electric utilities, clearly calls for extreme caution. The

electric industry's structure and product/service is completely different from other industries in which deregulatory experiments have been conducted, with very mixed results: natural gas, telecommunications, airlines, trucking, health care. Indeed, deregulation in some industries, especially the thrift industry, has had disastrous results. Therefore, we should focus carefully and exclusively on the electric utility industry in deciding whether to take another leap into the dark waters of illusory "competition" with debt-financed unregulated ventures.

In short, I believe that if we are unsure of what the outcome of experimentation will be, then the prudent course of action is more careful study. Before major loopholes are created in PUHCA, it is essential that the Banking Committee exercise its historic jurisdiction and responsibility to examine this legislation. To preserve reliability, reasonable costs and the public benefits of the vertically integrated system, it would be extremely unwise to seek to alter "incrementally" this very complex system in the name of "competition" or other economic theory without first investigating, evaluating and carefully determining how such changes might affect our nation's entire electric system over the long term. This was recommended by the Office of Technology Assessment in 1989 and most recently by the Congressional Research Service.

It takes many years to plan and build base load generating plants and transmission lines. Large generating plants well maintained and modernized may have useful lives of 40 years or

more. Decisions to build or not to build, once made, can have long-lasting impacts and repercussions on the availability, reliability and cost of electricity to the public. If short-term, tax-driven comparisons of fuel costs and capital costs are made versus an analysis of long-term costs and trends, then seemingly expedient choices may be made today at the expenses of higher costs and unreliable service tomorrow.

I hope the Subcommittee -- and ultimately the full Committee -- will consider carefully the conclusions of the Congressional Research Service's recent report on proposals to restructure the nation's electric power industry. According to CRS:

Whatever else may be said about the current regulatory system, it has worked. The Nation has enjoyed many decades of available electricity at prices well within the norm for industrialized world. And, there is every indication that the system will continue to respond to changes in technology, utility structure, and consumer needs. The major reason why the system has worked is because of the ingenious scheme of regulation devised at the time of the enactment of the Federal Power Act and the Public Utility Holding Company Act. That scheme was forged a half-century ago in an effort to provide a flexible balance between Federal and State regulation for the purpose of assuring competent regulation and reliability of service.

The coordinated Federal and State regulation that was established in the 1930s was characterized by elegance, simplicity, and flexibility. It strikes a delicate balance that left the States with extensive retail rate authority and confined Federal jurisdiction to interstate bulk sales of power. State regulatory controls were fostered by Federal law through the elimination of extensive interstate holding company involvement in electric utilities.

Congressional Research Service, *supra*, at CRS-363. Significantly, CRS concluded that:

It is difficult to see the case for a comprehensive revision of electric power regulation. . . . Instead, proponents of regulatory change should be required to bear the burden of proof for benefits that might come from dramatic change.

Id. at CRS-364--365.

In my view, Title XV, in addition to undermining the financial soundness of the electric power industry, would be bad energy policy. I want to lay to rest one argument sometimes advanced by advocates of Holding Company Act deregulation, which is that we face some sort of electric power shortage in this country. Certainly, there is no electricity supply crisis in this country which mandates the drastic restructuring of the electric utility industry contemplated by this legislation. The highly respected North American Electric Reliability Council reported in its most recent assessment that "Electric utilities have adequate plans for the 1990-1999 period to provide reliable electric service to their customers." Regulated utilities will meet anticipated demand, in part, by buying power from non-utility generators which will be developed under current law, as well as by enhancing performance of existing units, building new utility generators, and purchasing power from neighboring utilities. See North American Electric Reliability Council, 1990 Reliability Assessment: The Future of Bulk Electric System Reliability in North America 1990-1999, at 4. Indeed, the supply picture appears to be improving. Whereas in its 1989 assessment,



NERC estimated that total U.S. capacity margins would be 17.6 percent in 1998, the 1990 assessment projects a higher reserve margin of 18.5 percent in 1998. Cf. NERC, 1989 Electricity Supply & Demand For 1989-1998, at Table 8; NERC 1990 Electricity Supply & Demand For 1990-1999, at Table 8.<sup>3/</sup>

Finally, the Subcommittee should be aware that attempts may be made to amend Title XV of S.1220 to give the Federal Energy Regulatory Commission broad new powers to order utilities to transmit or wheel power from EWGs to the utilities own customers. Such mandatory transmission requirements are the next item on many EWG advocates' agendas. These proposals will be touted as merely mandating transmission access for "wholesale" sales by EWGs.

However, transmission "access" proposals are but the first step toward full-blown retail wheeling. Such a regime would permit EWGs to make direct sales to, e.g., large industrial customers, with delivery of the power through mandated

---

<sup>3/</sup> Even the limited and localized potential electric supply constraints identified by NERC's 1989 assessment as potential problems have essentially vanished. NERC's 1990 reliability assessment, at Table 8, projects that the North East Power Pool (NEPOOL) will have a capacity margin of 16.7 percent in 1998, double the margin projected only a year earlier.

These figures bear out the conclusion of Technical Annex 1 to the President's National Energy Strategy. That study, though flawed in many respects accurately dismisses as a strong or credible argument for amending PUECA the notion that there is an impending capacity "gap" which can only be filled by deregulated EWGs. See National Energy Strategy Technical Annex No. 1 (prepublication copy, n.d.) at 65.

transmission via the native utility that formerly served the customer (and may still have to provide back-up power to it). This result may be attractive to some small number of large industrial consumers of electricity, but could be very costly (and unnecessarily so) for the small commercial and residential electric consumer who would have to pay more of the operating and capital costs of the electric system, including the cost of any unused generating capacity.

Indeed, even sales at wholesale by EWGs to former requirements customers of a regulated utility, such as a municipal utility or a rural electric cooperative, could saddle the generating utility's remaining customers with the costs of large amounts of "stranded investment" originally incurred to serve that customer and, indirectly, its customers. We strongly oppose any system of mandatory wheeling -- wholesale or retail -- that could so jeopardize the financial health of electric utilities and their smaller customers. The Federal Energy Regulatory Commission already has sufficient authority in unusual situations of public need to require wheeling -- a power rarely needed and rarely invoked precisely because the current voluntary system of wheeling based on mutual benefit to the parties (and their customers) works so well.

In conclusion, Title XV raises a fundamental public policy question: Would the nation's critical need for an abundant, reasonably priced, reliable supply of electricity over the next decade and beyond be well served by increased dependence on

highly-leveraged third-party generation facilities owned by unregulated holding companies whose costs of service and profits will be undisclosed and which will operate with no obligation to serve the public? The answer clearly is No. Congress' own advisers have concluded that the case for PUHCA amendment has not been made. The Office of Technology Assessment (OTA) cautions that:

[T]he costs and benefits of competition are very uncertain. . . . Actual experience is limited, and little analysis has been performed. . . . The benefits of competition are speculative and difficult to quantify

Office of Technology Assessment, Electric Power Wheeling and Dealing, at viii (1989). OTA concluded that:

[E]ven without legislative action, the competitive segment in the electric power industry is growing. . . . These trends are likely to continue. . . . There is no crisis mandating immediate action by policymakers.

Id. at 27. Similarly, CRS concluded that proponents of PUHCA exemptions and other basic changes to industry structure should be required to "bear the burden of proof" that such changes will result in even better performance by the electric power industry. CRS, supra, at CRS-365. In light of these uncertainties, and the potential for yet another disastrous deregulatory experiment, we believe that the Banking Committee should not abdicate its historic responsibilities to fully consider Title XV of S. 1220 and oversee this and any other proposals to create loopholes that would deform -- not reform -- the Holding Company Act.



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September 23, 1991

Honorable Christopher Dodd  
Chairman  
Subcommittee on Securities  
Committee on Banking, Housing  
and Urban Affairs  
534 Senate Dirksen Office Building  
Washington, D.C. 20510

Dear Mr. Chairman:

Thank you for your leadership in organizing and moderating Tuesday's hearing on PUHCA reform issues. I was pleased to see the large number of Banking Committee Members in attendance, reflecting a high level of interest in these important issues. I was especially pleased that both Chairman Riegle and you are committed to watching PUHCA issues as the National Energy Strategy bill moves through the legislative process.

Although Senator Shelby asked the Banking Committee not upset the Energy Committee's "delicate balance" on PUHCA reform, we firmly believe that this "balance" was badly skewed; the interests of consumers and independent power producers were not adequately addressed. Consequently, I urge you to support the Fair Competition Amendment developed by an ad hoc group of consumer advocates, environmental groups and independent power producers including Destec. The Fair Competition Amendment, which is enclosed, addresses two critical flaws in Title XV by (1) granting FERC authority to order utilities to provide transmission service on a case-by-case basis, and (2) banning self-dealing between a utility and its affiliated wholesale generator.

Due to the format of the September 17 hearing, I did not get an opportunity to respond to a number of misleading statements made by others on the panel. Because these issues are so critical, I am enclosing a short paper setting forth my supplemental views on several issues raised at the hearing. I respectfully request that these materials be included in the record of the subcommittee hearing.

A SUBSIDIARY OF THE DOW CHEMICAL COMPANY



Honorable Christopher Dodd  
September 23, 1991  
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On behalf of Destec, and its largest shareholder, The Dow Chemical Company, let me again express my appreciation for your interest and leadership on these important issues. We look forward to working with you further to craft PUHCA reform legislation that will truly benefit consumers.

Sincerely,

A handwritten signature in cursive script, reading "Keys A. Curry, Jr.".

Keys A. Curry, Jr.

Enclosures

cc: Subcommittee Members

**SUMMARY OF SUPPLEMENTAL COMMENTS OF  
KEYS A. CURRY, JR.  
EXECUTIVE VICE PRESIDENT OF  
DESTEC ENERGY, INC.**

**Before The**

**SUBCOMMITTEE ON SECURITIES OF THE  
COMMITTEE ON BANKING HOUSING AND URBAN AFFAIRS**

**Concerning**

**TITLE XV OF S.1220,  
THE NATIONAL ENERGY SECURITY ACT OF 1991**

On behalf of Destec Energy, Inc., Keys A. Curry, Jr., offers the following supplemental comments on issues raised during the hearing before the Securities Subcommittee concerning PUHCA reform held on September 17, 1991:

- Consumer Benefits Will Result from True Competition. Fair competition in the bulk power market will inevitably reduce utility rates for consumers.
- Transmission Access and Ban on Self-Dealing Are Needed to Produce a Truly Competitive Market. The Fair Competition Amendment sponsored by an ad hoc group of consumer advocates, environmental groups and independent power producers (IPPs) such as Destec is a narrow and targeted amendment designed to discourage anticompetitive denials of transmission access and prevent abusive self-dealing in the new competitive bulk power market.
- Consumer Advocates, Not Utilities, Represent Ratepayer Interests. Although utilities often couch their positions in terms of protecting consumer interests, the groups which truly speak for consumers are consumer advocacy groups such as the Consumer Federation of America and the Electricity Consumers Resource Council. CFA and ELCON have been integral to developing and supporting the Fair Competition Amendment to improve transmission access and ban self-dealing.
- Transmission Access Works. Destec's experience in Texas shows that independently generated power can be transmitted by utilities without adverse reliability impacts, generating substantial revenues for the transmitting utilities with little or no additional investment required.

- A Ban on Self-Dealing Will Not Keep Utilities Out of the New Competitive Market. Self-dealing restrictions will simply bar a utility from dealing with its own PUHCA-exempt affiliate. The utility affiliate would be free to sell power to any other utility in the country.
- The Distinct Purposes of PURPA and PUHCA Reform Should Not Be Confused. The mandatory purchase provisions of the Public Utilities Regulatory Policy Act (PURPA) were intended to promote use of alternative generation technologies and cogeneration, not to reduce utility rates. In contrast, utilities will be under no obligation to purchase power from PUHCA-exempted IPPs. Competition among IPPs to win power contracts will drive prices down, for the benefit of ratepayers.
- IPPs Are No More Leveraged than Utilities. The fundamental assumption that IPPs are more leveraged than utilities is incorrect. Consequently, statutory restrictions on IPP leverage are unnecessary.

**SUPPLEMENTAL COMMENTS OF  
KEYS A. CURRY, JR.  
EXECUTIVE VICE PRESIDENT OF  
DESTEC ENERGY, INC.**

**Before The**

**SUBCOMMITTEE ON SECURITIES OF THE  
COMMITTEE ON BANKING HOUSING AND URBAN AFFAIRS**

**Concerning**

**TITLE XV OF S.1220,  
THE NATIONAL ENERGY SECURITY ACT OF 1991**

The large number of witnesses on the September 17 panel made it difficult to comment on all of the important PUHCA-related issues raised during the hearing. Consequently, I thought it would be helpful to offer my supplemental comments on several of the issues raised during the panel discussion. In particular, I wanted to respond to several of the misleading assertions made during oral remarks, in order to avoid leaving the Subcommittee Members with any misimpressions about these critical policy issues.

**I. Consumer Interests Will Be Served by PUHCA Reform If Both  
Transmission Access and a Ban on Self-Dealing Are Included.**

There was much discussion at the hearing about whether PUHCA reform would be good or bad for electricity consumers. Destec firmly believes that legislative reforms that will foster true competition in the wholesale power market will inevitably lead to



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Destec Energy, Inc.  
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lower utility rates. Thus, the question is what legislative reforms are needed to produce true competition. As explained in my prepared testimony filed prior to the hearing, Title XV of S. 1220, as currently drafted, will not produce fair competition and therefore is unlikely to result in real consumer benefits. In order for PUHCA reform to achieve a truly competitive market, at least two additional issues must be addressed in this legislation:

1. Transmission Access. The current law that bars FERC from ordering utilities to provide transmission services if such an order would affect existing competitive relationships must be lifted. Instead, FERC should be granted the authority to order utilities to provide transmission services if such would increase competition in the bulk power market, consistent with service reliability and with fair compensation for the transmitting utility.
2. Bar Self-Dealing. Utilities that establish PUHCA-exempt wholesale generating affiliates must be barred from self-dealing with those affiliates.

These changes to Title XV are the elements of the Fair Competition Amendment discussed in my prepared testimony. A copy of this simple amendment and a list of the groups endorsing the amendment are attached.

Many witnesses representing different positions in the PUHCA debate suggested that their position was based on protecting the best interests of consumers. It must be noted, however, that the interests of ratepayers can best be discerned by the advocates

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Destec Energy, Inc.  
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that represent consumer interests, not from utility representatives who represent utility stockholders.

The Consumer Federation of America (a federation of over 240 pro-consumer organizations with some 50 million individual members) and the Electricity Consumers Resource Council (an association of 21 large industrial consumers of electricity that consume nearly 5 percent of all electricity sold in the U.S.) have been active in this PUHCA debate. These consumer organizations have played an integral part in the ad hoc coalition of consumer advocates, environmental groups, and independent power producers (IPPs), such as Destec, that has developed and is now actively supporting the Fair Competition Amendment discussed in Destec's prepared testimony. In addition, James Leahy of the Connecticut Public Interest Research Group, a Connecticut-based consumer advocacy organization, testified at the September 17th hearing in favor of amendments to prohibit self-dealing between utilities and their affiliates, and to empower FERC to order transmission access.

**II. Expanded FERC Authority to Order Transmission Access Is Both Necessary and Workable.**

Mr. Sykora of Houston Light and Power suggested that transmission access was part of Destec's "hidden agenda" in PUHCA reform. Our concern about utilities' denial of transmission services and the anticompetitive effects of such denials are not

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hidden. Destec firmly believes that PUHCA reform will not result in a competitive wholesale power market, with all of the consumer benefits that such a competitive market would bring, unless all power generators can get access to transmission services over which electric utilities exercise monopoly control. Simply stated, true competition cannot develop until producers can get their product to market, that is, to the utility that wants to purchase the power.

Contrary to the suggestions of several witnesses, independent power producers such as Destec do not seek transmission services at some subsidized or confiscatory rate. As currently provided by section 212 of the Federal Power Act, FERC cannot order utilities to provide transmission services unless the transmitting utility will be fully reimbursed for the reasonable costs of providing those services, including the costs of any enlargement of transmission facilities, plus a reasonable rate of return. The details of how such tariffs for transmission services should be set is a regulatory issue for the FERC, not a legislative issue for Congress.

It was also suggested at the hearing that providing transmission services to third parties is a new phenomenon that raises new questions about how to price services and ensure reliability. In fact, transmission services are bought and sold by utilities all of the time, without adverse consequences on

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reliability or problematic pricing issues. Most commonly, utilities buy and sell transmission services from each other as power is moved across the power grid. These cost based rates are tariffs or contracts that are filed with the FERC on a regular basis. Moreover, Destec has years of experience in obtaining transmission services to move power within the area of the Electric Reliability Council of Texas. Destec has been or is a party to the megawatts power generated on the Gulf coast to Houston Light and Power. This power is transmitted under transmission service tariffs first established by the Texas Public Utility Commission in 1986. Indeed, cogenerated power in Texas pays roughly \$15 million per year for wheeling services.

**III. A Ban on Self-Dealing Will Not Significantly Affect Opportunities for Utility Affiliates to Participate in the Bulk Power Market.**

It was suggested during the hearing that a ban on self-dealing would somehow keep utilities, with all of their expertise and resources in building new generating capacity, out of the bulk power market. Self-dealing restrictions would do no such thing. The self-dealing restriction in our Fair Competition Amendment, for instance, would simply bar utilities from setting up PUHCA-exempt generating affiliates that would sell power at market-based rates to their affiliated utilities. Utility-affiliated exempt generators would be free to sell power to any

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non-affiliated utilities in the country, leaving plenty of opportunity for utilities to profit from their accumulated skills. So, for instance, Consumers Power could establish a PUHCA-exempt affiliate to generate and sell power to any utility in the U.S. except Consumers Power.

A ban on self-dealing is consistent with the position taken by the Department of Energy in its National Energy Strategy:

In a broadly competitive market, prospective sellers would face many possible buyers; the loss of the option of selling to themselves would not reduce the number of buyers appreciably. Similarly, the prospective buyer's options would be constrained little by not being able to buy from an [affiliate]. Thus it appears that there would be little loss of economic efficiency in banning self-dealing and it would eliminate a major source of concern about possible adverse impacts on consumers.

U.S. Department of Energy, National Energy Strategy: Analysis of Options to Amend the Public Utility Holding Company Act of 1935, Technical Annex 1, at 33 (1st ed. 1991/1992).

#### IV. The Distinct Purposes of PURPA's Mandatory Purchase Requirement and PUHCA Reform Should Not Be Confused.

Several witnesses testified that PUHCA reform would increase consumer costs, based on the argument that purchases from "qualifying facilities" have raised rates. These assertions are misleading on several counts.

First, it is important to understand that experience with power purchases from alternative power sources and cogeneration facilities (collectively qualifying facilities or QFs) under the

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Public Utility Regulatory Policy Act (PURPA) is not a good predictor for the likely rate impact of increasing power purchases from independent power producers. PURPA requires the local utility to purchase power at a rate equal to the utility's avoided cost, that is, the cost the utility would have paid to generate the same power. These avoided cost rates are established by state commissions, and as you heard on Tuesday, there are some in the utility industry who believe that some states have set avoided cost rates too high. In contrast, utilities are under no obligation to purchase power offered by independent power producers, and are not required to pay any minimum rate if they do purchase such power. The rate is set in a free, competitive market -- the utility will take the best rate it can get.

Second, in the face of the utilities' objections to PURPA's mandatory purchase requirement, it is important to remember that the stated Congressional purpose of PURPA was not to lower consumer rates or promote competition. Instead, PURPA was enacted in 1978 in the midst of an oil supply crisis with the purpose of promoting the development of alternative generation technologies and efficient cogeneration facilities without any net loss to the consumers. In contrast, PUHCA reform is driven primarily by the goal of using fair competition in the wholesale power market to drive down costs for the benefit of consumers.

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It is simply illogical to judge PURPA by Congressional purposes never ascribed to that legislation. Judged by Congress' 1978 purpose of promoting alternative energy and conservation of power, most commentators judge PURPA to have been both effective and successful.

Frankly, some of the complaining by the utilities about avoided costs under PURPA is simply sour grapes. Houston Light and Power purchases 325 megawatts of cogenerated power from Dow. Soon after these purchase contracts were negotiated in 1985, HL&P estimated in its Energy Efficiency Plan that:

the net present value of the projected savings to our customers, over the 10-year term of our firm capacity contracts with Dow, Diamond Shamrock and Bayou, is \$148,707,000. This is our estimate of the savings attributable to HL&P's success in negotiating capacity payments at levels which are lower than our estimate of avoided capacity costs.

As the relative costs of coal and gas have shifted over the last five years, HL&P has grown dissatisfied with the deals that it negotiated in 1985. The fact remains, however, the HL&P negotiated a power purchase contract that it believed was in the best interests of its consumers and at a price discount compared to its own plan to build generation.

**V. Special Review of Debt Levels is Unnecessary Because IPPs Are Less Leveraged than Utilities.**

The entire argument that IPPs have some competitive advantage due to their high debt to equity ratio is based on a

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false premise that IPPs carry more debt than utilities. In fact, IPPs are typically less leveraged than utilities.

IPP projects are almost always financed using project financing, i.e., the debt is secured by the power plant assets of a single project and the cash flow from the sale of the electricity generated by the project is pledged to retire the debt. IPP projects typically start with 80% debt, to be paid over a term of 12 to 15 years. Thus, as shown in the attached chart, an IPP pays down its debt level rapidly, with all debt retired by year 15. Over the course of a 30-year power project, an IPP that begins with 80% debt financing has, on the average, outstanding debt of only 24%. Even if the project is refinanced at the end of the first 15-years, the average outstanding debt rises to only 48%.

In contrast, electric utilities use corporate debt, which is typically maintained at a relatively steady level. On average, investor-owned electric utilities are capitalized with 57% debt, and public power companies are 97% debt financed. Thus, while IPP projects may have debt levels higher than utilities in a few early years of a project, IPPs carry substantially less debt on average over the course of a project.

Moreover, the truly independent wholesale generators have no special financial advantages relative to utility-affiliated



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Destec Energy, Inc.  
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generators. Utility affiliates can use the same type of project financing that IPPs typically use.

Given that IPPs are typically less leveraged than utilities, Destec submits that the special leverage provisions of section 15107 of S.1220 are unnecessary and should be dropped.

**IPP CAPITAL STRUCTURES -  
SHOULD LEVERAGE LIMITATIONS BE LEGISLATED?**

**ISSUE**

Should debt ceilings, such as those required for electric utilities, be imposed on the new generation of independent power producers (IPPs) that are expected to generate an increasing share of electric power if PUHCA is reformed?

**ANSWER**

Because of fundamental differences in utility corporate debt and IPP project debt, debt ceilings for IPPs should not be codified in federal legislation.

**UTILITIES USE  
DEBT  
DIFFERENTLY  
THAN IPPS**

Electric utilities issue corporate debt, typically for a 30-year term, to finance investments. Utility debt ratios have been capped by the Holding Company Act and state rate regulators in order to police utility practices of issuing debt to maintain high dividends and thereby inflate stock values, to the detriment of ratepayers and investors.

IPPs incur relatively short-term (e.g., 15-year term) debt committed to the construction of specific projects pursuant to non-recourse project financings. This debt can be used for no purpose other than construction of the subject project. IPP debt therefore cannot be diverted to dividends or elsewhere to the detriment of consumers or investors.

**IPP CAPITAL STRUCTURES** (continued)**IPPS CARRY  
LESS DEBT  
OVER  
PROJECT  
LIFE**

IPP project financings typically start with approximately 80% debt; project cash flow is pledged to retire that debt within 15 to 20 years of a 30-year project life.

As shown in the accompanying graph, average debt over an IPP project life, assuming a conventional 15-year term loan, is only 24% (or a maximum of 48% if refinanced for an additional 15-year term loan). This is substantially less debt than the 57% average debt held by investor-owned electric utilities and the 97% average debt held by public power companies.

**IPP LEVERAGE  
DOES NOT  
COMPROMISE  
RELIABILITY**

-----  
NO IPP OR QF HAS EVER FAILED TO MEET ITS POWER SUPPLY OBLIGATIONS AS A RESULT OF FINANCIAL DEFAULT.

Leverage is a financial risk only insofar as cash flow is inadequate to service debt over the term of a loan. Revenue to an IPP project is fixed by a power sales contract eliminating demand-related risk at the outset.

In addition, before an IPP project is financed and constructed, the IPP's ability to generate adequate cash flow from power sales revenues is rigorously reviewed by the developer, the purchasing utility, the lenders and the equity investors. The scrutiny of each of these

**IPP CAPITAL STRUCTURES** (continued)

interested parties ensures that there will be adequate project revenue to retire the debt.

**CONCLUSION**

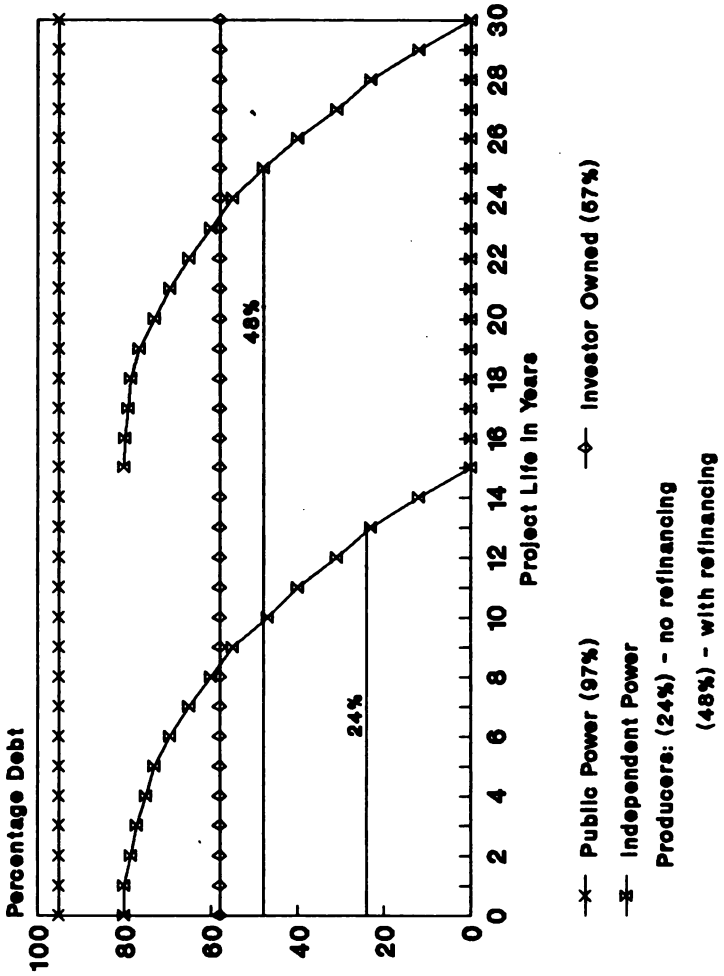
Legislating IPP capitalization requirements is unnecessary because:

(1) IPP project debt is not subject to the abuses that the Holding Company Act and State regulation have policed via debt ceilings;

(2) IPPs have substantially less debt over project life than either investor owned utilities or public power; and

(3) NO IPP OR QF HAS FAILED TO MEET ITS POWER SUPPLY OBLIGATIONS. Stable demand and revenue, together with extensive financial review, ensures the adequacy of cash flow.

## Debt By Project Ownership Type



# **Risk Shifting and Its Consequences in the Electric Power Industry**

***PUHCA Changes and Independent Power Development***

By  
Dr. David G. Raboy  
Chief Economic Consultant  
Patton, Boggs & Blow  
Washington, D. C.

***Prepared for the Electric Reliability Coalition  
May 29, 1991***

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## EXECUTIVE SUMMARY

This study investigates the consequences of changes in the Public Utility Holding Company Act (PUHCA) such as those to create Exempt Wholesale Generators -- independent power producers (IPPs) that would be exempt from PUHCA restrictions. The focus of the debate on the desirability of PUHCA change has shifted from concern over sufficient future supply capacity to a debate on economic efficiency in the generating sector. Accordingly this study analyzes the effects of proposed PUHCA changes in light of standard economic efficiency criteria. The general findings of the study are as follows:

- It is generally agreed that IPPs will be funded with 80 to 90 percent debt or even higher.
- It is noncontroversial to state that IPP debt will have only a small risk premium in interest rates -- contrary to what would be expected for a highly leveraged entity in a free market setting.
- Financial theory holds that as a company's debt percentage in capitalization increases, the costs of debt and equity should increase, reflecting the additional risk of financial distress. This does not happen with IPP financing because the IPP is able to shift the financial and operating risk that would normally be associated with the developer of a power project in a free market setting to the purchasing utility. The risk shifting occurs because all contracts, take or pay and take and pay, will include minimum capacity payments to the IPP which is the mechanism by which risks are shifted.
- Because of the risk shifting, the IPP is able to take advantage of the tax advantage of debt without incurring substantially higher interest costs and, therefore, the IPP can produce an artificial cost of capital advantage.
- The risk shifting results in a "market failure" -- the utility is forced to bear risks without compensation. The result is a distortion of the prices of electricity, making it

difficult to choose the most economically efficient generation source. Due to the market failure, IPP power will appear to be less expensive when in reality it is not, leading to greater total consumer expenditure in the long run.

- The risks that the utility must bear, but is not paid by the IPP to bear, must show up somewhere. Either the utility's bond rating will be degraded and/or the utility will have to increase its equity. Thus, the utility's cost of capital will increase which will either have to show up in the rate base as the utility adds, replaces, or maintains generation, transmission or distribution facilities, or will result in decapitalization of the utility. In any event the ratepayer will eventually suffer the consequences of uncompensated shifted risks.
- Fundamental to the hypothesis that a market outcome yields the most efficient and cost effective results is the prerequisite that all entities face the same potential for reward and risk. It is antithetical to a free market concept to allow some entities to shift risks to the very companies they are competing against without compensation. The analogy is to a situation where one set of companies is subsidized by the government and competing companies are taxed to pay for the subsidy. The subsidized companies will win any competition even though they are less efficient. The unequivocal result of a subsidized market is economic inefficiency and higher total costs.
- Because of the artificial cost of capital advantage produced by a combination of uncompensated risk shifting and the tax advantage of debt, an IPP will exhibit one or a combination of the following results:
- All else held constant, an IPP will be able to win every bid because of the capability to artificially offer bid prices 5 to 10 percent below a native utility.
- An IPP will be able to offer exorbitant equity rates of return and still remain competitive with a utility. IPP equity rates could range as high as 28 percent.
- An IPP could be highly inefficient and still be price competitive with a utility. An IPP could absorb, for instance, cost overruns equal to 10 percent of total project cost and still pay debt and equity holders their required rates of return, having already underbid a utility.

## I. Background

### Introduction

In recent years substantial effort has been expended towards analyzing the efficacy of competition in the electric power generation sector. Initial concerns were that existing investor owned utilities (IOU) were not investing sufficiently to meet future capacity needs. A new alternative was needed, it was argued, to meet future electricity demand and independent power producers (IPP) provided a viable option.

Recently the capacity concerns seem to have subsided and the debate has become an extension of the general debate on deregulation. The electric power industry is seen by proponents of change as the last bastion of government regulation of important industrial sectors and the argument is made that increased competition can only lead to greater efficiency in generation. The previous conventional wisdom, that electricity was a natural monopoly, is challenged by some economists who argue that only transmission and distribution remain natural monopolies but generation can be enhanced by competition. Other economists argue that generation still is a natural monopoly.

At this point, the debate on the efficacy of competition in the generation segment is largely theoretical with reputable economists lining up on both sides of the aisle. But it should be noted that those reputable academic economists that advocate deregulation of the generation sector advocate complete deregulation.

lation--where all utilities and non-utilities are free to compete under the same set of rules.

Under a truly competitive system all entities would have the same right to succeed or fail, to enter or exit a market and to diversify by entering other lines of business. In a competitive situation all entities would be covered by the same set of government regulations at both the state and federal levels, there would be no subsidization of one set of entities by another within the same market, and most important, all entities would have the same relationship to risk and reward. One set of competitors would not be able to shift financial risks to the very companies they are competing against while denying their competitors compensation for the new risks they must bear.

Should a true deregulation proposal ever surface, economists and policy makers will have to tackle the question of whether unfettered competition in the electric generation segment will foster increased efficiency and better consumer wellbeing. It is beyond the purview of this paper to analyze competition in a truly competitive generation market but the prospect of a competitive generation sector is no where in sight. Instead, this paper will focus on the consequences of current proposals to amend the Public Utility Holding Company Act (PUHCA).

#### PUHCA Changes

Recently proposals have been introduced in the Congress to create a special class of IPPs, known as Exempt Wholesale Generators (EWG), who would be exempt from the restrictions of PUHCA.

The current proposal, which began life as S. 406 in 1989 and is now modified to be Title XV of the National Energy Strategy Act of 1991 in the Senate and part of similar legislation in the House, appears innocuous on its face although its exemption of a select group of potential competitors (IOUs as corporate entities would still be subject to PUECA if, for instance, they attempted to diversify into other lines of business, and are still subject to PUECA regarding existing facilities in their service areas) would immediately disqualify it as a deregulation proposal.

Although the bill ostensibly merely removes a regulatory impediment to IPP development, if nothing else were to change the generation landscape would be altered dramatically with the passage of the PUECA exemption. What would result would not be competition in any economically meaningful sense, but rather the entry of subsidized IPPs into the generation segment who could compete with IOUs, not because of any inherent efficiency properties, but rather because they enjoy a systematic cost of capital advantage produced by a combination of the tax advantage to debt and the ability to shift much of the financial risk to purchasing IOUs without compensation.

The IPPs that enter the market in a post-PUECA change world will not be start-ups developed by entrepreneurs who seek venture capital on Wall Street. They will either be the subsidiaries of existing IOUs operating outside of the parent's service territory or other large construction or manufacturing firms with experience with generating equipment.

These IPP entrants will be able to compete on an unequal basis because the likely contractual arrangements between IPPs and IOUs will impose new risks on IOUs. Because the IPP can shift most market and operational risk to the IOU, it can employ large amounts of debt in its capital structure without incurring the substantial debt and equity risk premiums that would normally counteract the tax advantage to debt. The net effect is a systematic, artificial cost of capital advantage and/or a masking of financial risk such that projects that the free market would normally consider uneconomic relative to other alternatives become attractive solely because financial risk is transferred and taxpayers effectively subsidize the equity return.

The IOU is not compensated for the transfer of risk because of the existence of a financial "market failure." That is, the complex interaction of state and federal regulatory bodies with regulated IOUs and unregulated IPPs in a partially deregulated environment results in a situation where in many cases an IPP can impose risks and costs on an IOU without compensating the IOU. This occurs, of course, because the market for generation in a post-PUHCA change world would in no way represent an economist's concept of a competitive market.

### Consequences of Market Failure

When there is a shifting of risks such that the necessary linkage between risk and reward is broken, a market failure, not a competitive market, results. Free market economists are well aware of the consequences of externalities where one party makes

decisions based on only a portion of the costs of those decisions while others bear the risks and costs of those decisions. Recent writing by financial economists, including Nobel Laureate Harry Markowitz, has addressed the financial crises of the 1980s. Most notably these economists argue that the excesses of the 1980s were not the result of debt per se, but rather that in the notorious cases, those enjoying the benefits of the debt were able to shift the attendant risks onto other parties.

The same message applies to IPP development in the current context. Policy makers should be concerned that the predictable financial games might produce serious economic inefficiency. This paper predicts that the changes sought in PUHCA will result in the following events. The artificial cost of capital advantage to the IPP that results from uncompensated risk shifting and the tax advantage to debt can take three forms or a combination of the three. Due to the artificially low required annual return, in a bidding procedure with an IOU an IPP could systematically win every bid by pricing electric power 5 to 10 percent lower than an IOU while still paying shareholders their required minimum returns. Alternatively, the IPP could price electric power just below the IOU's bid and pay equity holders exorbitant rates of return, well in excess of the required minimum. Clearly such an outcome would seriously distort the proper flow of investment funds in the electric power industry. Finally, the artificial capital cost subsidy could encourage economic inefficiency. IPPs could absorb cost overruns that are substantial

portions of project cost (10 percent of total project cost and higher), pay equity holders their hurdle rates and still price electric power just under an IOU's bid.

### Organization of the Paper

Section II of this paper discusses the risks inherent in the electric generation sector. It describes how risks would be shifted in a post-PUNCA change world and the institutional parameters that assure that IPPs will not have to compensate IOUs for increased risk taking. Section III is an empirical examination of the consequences of the market failure described in section II. This is followed by a technical Appendix which describes the methodology used to produce the results in section III.



## **II. Elements of Risk in Electric Power Generation**

There are three fundamental areas of risk that are associated with the generation of electric power and that must be accounted for in any scenario where an IOU is purchasing power from an IPP. These are construction risk, market risk and operations risk. This section will describe each area of risk and discuss who bears the burden of such risks in a purchase power situation and whether it can be expected that there will be compensation for shifted risks. The section concludes with a discussion of scenarios under which IOUs can be made to bear risks without payment.

### **Construction Risk**

Construction risk concerns the possibility that facilities will not be built on time or on budget or that specifications will not be met, leading to extra expenditures in the future. Current perceptions of construction risk are based on prior experience with cost overruns and rate base disallowances, generally associated with central station, baseload facilities.

It should be noted that to the extent that the next generation of capacity additions stresses gas turbine or combined-cycle technologies, rather than coal-fired or nuclear baseload facilities, construction risk will be less than in prior periods. Further, the ability exists for any project developer to shift construction risk to the constructor through the use of turnkey contracts.

One proponent of IPP power development, Joseph Kearney, CEO of PG&E-Bechtel Generating Company, has argued in Senate testimony that IPPs will be able to shift construction risk to the constructor:<sup>1</sup>

The reality from the risk standpoint is that the risks have been moved to other players, the contract with the constructor, for example, which has been the classic, large risk on the utilities, cost overruns, plant schedules and performance. Now, that is all undertaken by the contractors, and that is significantly why we can take these higher debt ratios, and it does not reflect any higher risks to the project itself.

Of course IOUs would have the same option to shift construction risk as an IPP and for this reason, many argue that construction risk is strictly neutral between IPP and IOU development.

To the extent that either IPPs or IOUs bear any construction risk for the next round of capacity additions one point is crucial. As will be shown, because of uncompensated risk shifting by IPPs in the market risk area, coupled with the tax advantage of debt, IPPs will have a financial cushion that will allow them to absorb more in the way of cost overruns or delays and still be able to pay debt and equity holders the required income streams. That is to say, IPPs will have less of an incentive to discipline projects during the construction phase than will IOUs. This is described in section III of this paper.

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<sup>1</sup>Transcript of Hearings Before the Committee on Energy and Natural Resources, November 16, 1989, p. 78.

### Market Risk

For a developer of electric power generation market risk relates to the fear that customers will not exist in the future for planned capacity and therefore there will not be an assured revenue stream to cover debt and equity service. Market risk is at the heart of the risk shifting between IPPs and IOUs and it is probably the most serious risk facing any utility or non-utility developer of electric generation today. It is because of the uncompensated shifting of market risk that IPPs are able to employ such high levels of debt in their capital structures without facing excessive risk premiums in debt interest rates.

One must ponder whether any truly competitive market could sustain 90 percent debt levels for the various corporate entities. In no other competitive industry are such debt levels apparent. In manufacturing industries, for instance, capitalization ratios tend towards about 65 percent debt, and these industries are less risky than electric power.

There is an enormous amount of risk associated with long-gestation, capital-intensive investments where plant and equipment are highly specialized and completely immobile and fuel costs and load are uncertain over the life of the facility. It is not PUHCA that results in the levels of equity that exist in the electric power industry, nor are registered holding companies the only ones to have 50 percent equity in their capital structures. Because of the risk inherent in electric power, it is the market which requires such high levels of equity. If a corporate

entity in the electric power industry is able to sustain very high leverage, it can only be because the enormous risk is shifted off of that entity and on to someone else. Otherwise the risk premium in interest rates would far exceed the tax advantage to debt and, absent any major economic efficiencies, the leveraged entity could not compete.

The association of market risk with high IOU equity levels was recognized in a report produced by the Staff of the Senate Energy Committee:<sup>2</sup>

A typical electric utility has a capital structure with 50% debt and 50% equity. This reflects the fact that utilities have very tangible assets, yet their earnings can vary substantially with changes in sales or regulatory policy.

NUGs generally have a capital structure with 80 to 90 percent debt. This reflects the fact that NUGs (like utilities) have tangible assets in the form of a power plant. Most importantly, a NUG typically has a long-term power contract with a utility that assures stable revenues for the NUG. [emphasis added]

The significant fact is that the IPP is a wholesale producer selling to a retail seller with an uncertain market. The fact that the IPP has a contract "that assures stable revenues" while a utility's earnings can "vary substantially with changes in sales or regulatory policy" indicates that an IPP can escape

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<sup>2</sup>William Conway and Karl Hausker, Memorandum re: "Financial Issues in PUHCA Reform" March 13, 1991, p. 2.

market risk by shifting it to the IOU.<sup>3</sup> The method by which the risk is shed by the IPP is the contract it has with the IOU.

Take or Pay or Take and Pay: Does it Matter?

Much confusion exists on the type of contracts that will exist between IPPs and IOUs. Previously contracts were described as take or pay which entailed a "hell of high water" connotation. The implication was that the IOU would be obligated to pay for power whether the power was available. Now most observers feel that IPP power contracts will involve minimum availability clauses or minimum performance clauses in which the IOU would make capacity payments only when minimum standards were met. Such contracts are referred to as take and pay contracts.

Whether the contracts are "hell or high water" is irrelevant. For most reputable IPP developers, meeting the minimum availability requirements should not be difficult--especially when gas turbine or combined-cycle technologies are employed. What is relevant is the inclusion of capacity payments. Bankers will require contracts based on both energy and capacity payments. According to Charles R. Frank, Jr., Senior Vice President and Manager of Energy Project and Utility Financing for GE Capital Corp., the contracts that must exist would include the

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<sup>3</sup>It should be noted that the existence of tangible assets in no way protects against market risk in the area of electric power generation. Protection against market risk would only occur if the tangible capital were easily transferable; that is, it could be sold for full value in the event of financial distress. In fact, the capital employed by the electric power industry is "idiosyncratic." It is single purpose capital not easily transferred to other uses. As such, electric power capital would normally sell at much less than its underlying value in a distress situation.

following:<sup>4</sup>

We tend to favor pricing based on a capacity component defined in terms of dollars-per-kilowatt-per-month or year and on an energy component defined in terms of cents-per-kilowatt hour.

Pricing based on a single cents-per-kilowatt-hour component is more affected by output fluctuations and tends to be riskier to the financier...

The capacity charge should cover all costs which are not variable, including fixed operating costs, fixed fuel costs (such as demand charges for pipeline access) and financing costs, including debt service and a fair return to equity. [emphasis added]

It is the capacity payment component, the guarantor of debt service and the equity return, that produces the market risk shifting. This risk shifting occurs whether the contract is take or pay or take and pay.

It is for this reason that rating agencies are taking a new look at contracts other than take or pay contracts. Standard & Poor's, for instance capitalizes the payment stream under a take or pay contract and considers it a debt equivalent. But the agency is also concerned about the effects of take and pay contracts:<sup>5</sup>

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<sup>4</sup>Charles R. Frank, Jr. "Financiers of Alternative Energy Now Willing to Assume More Project Risk" *Cogeneration* September/October, 1989 at 34.

<sup>5</sup>Standard & Poor's "Utilities Credit Comment" March 26, 1990 at 2.

Because these obligations are less firm, S&P does not simply treat them as debt equivalents. Still, a utility's credit quality indicators can be adversely impacted since its overall fixed charges can increase dramatically. Once the relatively high availability factors are met by the NUC, the buying party is obligated to make the minimum capacity payments whether or not the power is actually used...

The growing fixed charges associated with purchased power also increase operating leverage. In other words, the ratio of cash fixed costs to cash variable costs could increase as the utility's operations are more dependent upon contractual obligations as opposed to owned capacity. Generally, the risk is significant when reliance on third-party capacity exceeds 10% of total capacity supply. S&P will analyze when reliance on third-party capacity exceeds looking at an adjusted fixed charge coverage which will incorporate cash flow coverage of when reliance on third-party capacity exceeds capacity payments. [emphasis added]

Moody's Investors Service takes a similar approach to take and pay contracts:<sup>6</sup>

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<sup>6</sup>Moody's Investors Service "Moody's Special Comment" August, 1990 at 5,6.

It is the utility's assumption of demand risk and the concomitant locking into a long-term firm contract with a fixed-cost component which represents the most significant drain on a utility's financial flexibility. One of the ways that Moody's dimensions the extent to which there has been erosion in financial flexibility is by attempting to quantify such fixed obligations. Specifically, we attempt to include the actual interest component of capacity or fixed payment obligations associated with long-term purchased power contracts in a utility's fixed-charge coverage calculation. In addition, we compute an adjusted-leverage ratio, including the related debt obligation as part of total debt.

#### Agreement on Shifting of Market Risk

There is considerable agreement that market risk is shifted from IPPs to IOUs in the presence of expected contractual agreements. According to Glenn McIsaac of Energy Management Associates, Inc.:<sup>7</sup>

These commitments typically provide the independent producers with an assured market and a known price for their facilities output. These assurances are extremely important because they assign the "market risk" to the utility rather than the IPP...

Under contracts which provide an assured market and an assured price to IPPs, the purchasing utilities bear the risk that the power will not be needed in the future or will be uneconomic relative to other sources of supply. These are the most significant risks associated with investment in electric generating facilities.

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<sup>7</sup>Glenn P. McIsaac "IPP Financing Advantages: Separating Fact from Fiction" Energy Management Associates, Inc., 1989, p. 12-3.



Glenn Ikemoto and Susan Carlow, two insurance industry executives, have noted the same effect:<sup>1</sup>

The long-term contract with price certainty and guaranteed sales removes the market risk from the venture. With an assured revenue stream, even the smallest developers finance huge projects on a non-recourse basis.

The Chairman of Dominion Resources and a proponent of IPP development, William Berry, seems to agree that the purchase power contract shifts market risk from IPPs to IOUs:<sup>2</sup>

And finally, there is the need for power. Do you really need this project? That risk is now borne by utilities and their customers and it would continue to be borne by utilities and their customers...

The utility retains some risk as I have indicated before, market risks, fuel price risks, and that we have a contract with the independent generator that shelters him from that risk and therefore he can take on that debt without adding to his business risk.

The contract that the independent producer has with the utility is an assurance of payment regardless of market demand and regardless of fuel prices because these two items in my judgement continue to be utility and utility customer risks.

It should be a relatively uncontroversial observation that the most likely contracting situations that will exist in a post-Title XV world will result in a shifting of the crucial market risk from IPPs to the purchasing utility. The utility will bear

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<sup>1</sup>Glenn Ikemoto and Susan Carlow "Power Contract Security: Balancing Price and Quality", mimeo, 1989, p. 11-2.

<sup>2</sup>Transcript *supra* at 74-76.

these additional risks without any compensation from the contracting IPP.

### **Operational Risk**

The most important components of operations risk are performance risk and fuel cost risk.

#### **Performance Risk**

Previously, Moody's Investor Services had argued that IPPs would shift operations risk to purchasing IOUs:<sup>10</sup>

If an "independent" turns out to be unreliable, the electric utility will be the one to be blamed by both customers and regulators. The utilities will have given up control over their generating sources and yet will continue to shoulder the responsibility for problems or changes in economic or legislative conditions. A lose-lose situation could develop from the utility point of view.

This same view was stated by Standard & Poor's, earlier:<sup>11</sup>

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<sup>10</sup>Robert W. Burke "Independent Power Producers and Their Impact on Utility Debt Quality" November 2, 1989, p. 8.

<sup>11</sup>Thomas D. Mockler, Standard & Poor's Corporation. Letter to Senator McClure, February 4, 1988, p. 3.

Unless state regulators are willing to accept bidding competition as a substitute for a utility's obligation to serve (a very unlikely eventuality) construction or operating shortcomings by a third party generator could result in regulatorily imposed penalties against the purchasing utility. Similarly, if contracted purchased power fails to materialize or proves to be unreliable the utility may be required to accelerate its own construction activities at a late date, thereby resulting in greater cost than previously anticipated and a greater risk of regulatory disallowance. The utility has an obligation to serve; the third party producers do not.

Currently Standard & Poor's considers purchased power to be inherently more risky from an operations standpoint:<sup>12</sup>

Because construction, financing, and operating risk associated with NUGs create concerns about reliability, S&P will generally expect higher reserve margins in companies with significant dependence on third-party generation, where significant is defined as over 10% exposure. While average reserve margins for utilities are considered adequate at 15% to 17%, increasing exposure to third-party generators may require reserve margins 3% to 5% higher than this average to compensate for higher reliability risk.

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<sup>12</sup>Standard & Poor's at 3.

Moody's has recently stated the following:<sup>13</sup>

Moody's considers it important to note that while many NUG plants are designed by the same engineers, built by the same construction firms and utilise the same equipment as these of existing central station utility plants, they are also typically built with less system redundancy and on a tighter budget than utility facilities. In addition, developers of NUG projects often are motivated to take their equity out as quickly as possible, perhaps to the detriment of the project over the long term. Issues such as these would be considered in the analysis of the operating risk associated with NUG purchases.

Proponents of IPP power agree that IOUs will and should bear the operations risks associated with purchased power. William Berry believes that the utility should retain operations risk:<sup>14</sup>

And on the other side you would have to say the utilities are taking on the risk as to whether these people actually perform under contracts. So, we have a shifting of risks.

#### Fuel Cost Risk

Fuel cost risk reflects the fear that fuels used in electric generation will become more expensive in the future. Charles Frank, of GE Capital Corp., states that his company is very sensitive to fuel cost risk and that GE "finds it much easier to

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<sup>13</sup>Moody's at 8.

<sup>14</sup>Transcript at 75.

finance projects relatively insensitive to energy prices."<sup>15</sup> This requires that the fuel risk be shifted in the energy component of the purchase power contract which "should cover the variable costs of running the plant."<sup>16</sup>

Discussions with investment bankers confirm that lenders will require some form of fuel cost escalator clause in the purchase power contract. These contracts may be based on general indexes rather than tied to a specific fuel so in that sense a minor part of the fuel cost risk may reside with the IPP.

Again, proponents of changes in PUHCA argue that IOUs should bear the fuel cost risk. William Berry argued the following in Senate testimony:<sup>17</sup>

Fuel price risk, the general cost of fuel, not a specific contract, but is oil going to triple or something like that, is now borne by utilities and their customers. And we think that under a good contract they should continue to be borne by utilities and their customers.

In short, operations risks, including performance risks and fuel cost risks, will be shifted from IPPs to purchasing utilities.

### Market Failures and Uncompensated Risk Shifting

The previous portion of this paper has described the three

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<sup>15</sup>Frank *supra* at 35.

<sup>16</sup>*Id.*

<sup>17</sup>Transcript *supra* at 74.

fundamental areas of risk associated with electric power generation and how these risks would be allocated when IPPs are selling power to IOUs. Construction risk is essentially neutral between the "build" and "buy" options. Market risk is borne by the utility in the build option and would be shifted from the IPP to the IOU in the buy option. Operations risk is borne by the IOU in the build option and would also be shifted from the IPP to the IOU in the buy option.

#### Market Evidence on Risk Shifting

The financial markets confirm that the risk shifting will, in fact, occur under purchase power contracts. This is apparent in the lack of expected risk premiums in debt interest rates for IPPs employing large amounts of debt in their capital structures.<sup>18</sup> The Senate Staff report has noted this phenomenon:<sup>19</sup>

Once again, the practice of junk-bond financing is essentially irrelevant to NUG financing. Junk bonds typically paid extremely high interest rates and did not have any stable source of revenues to pay off the bonds. The debt incurred by NUGs typically carries only a slightly backed by power sale revenues under a contract with a utility. [emphasis added]

In fact a survey of investment bankers and rating agency officers indicates that IPP debt rates would only be 50 to 100 basis points (one half to one percent) higher than utility debt.

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<sup>18</sup>The risk shifting is also evident in equity hurdle rates for existing well-known IPP developers. This is discussed in section III.

<sup>19</sup>Conway/Hausker at 4.

Joseph Kearney, of PG&E-Bechtel Generating Company and a proponent of IPP development states, "If there was any higher risk, we would not be able to finance the 80, 90 percent level which is generally where these [IPPs] are financed at."<sup>20</sup>

The financial markets are telling us that IPP debt is not terribly risky. How can that be when the electric business itself is very risky and the market will not allow those with ultimate responsibility for providing electricity to use large quantities of debt? Risk does not simply disappear. If IPP debt does not contain a substantial risk premium it can be for only one reason: The risk is shifted to the purchasing utility who, by the way, is also a competitor for the provision of power. It is a fairly obvious statement to say that in a truly competitive market, some companies cannot as a matter of course shift their financial risks to the very companies they are competing against.

It is the shifting of financial risks without compensation to IOUs that allows IPPs to take on extraordinary levels of debt without incurring the added risk-premium debt costs that serve as a normal source of discipline on financial structure. There is nothing inherently wrong or evil about debt, even debt at high levels. It is only when the risks and costs associated with debt are not properly considered or borne by those making the debt financial decisions that problems occur. When individuals can reap the financial and tax benefits of debt while shifting the costs of debt elsewhere, then distress will arise.

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<sup>20</sup>Transcript supra at 78.

Nobel Laureate Harry Markovitz made exactly this point in a recent lecture on the lessons of leverage in the 1980s. He noted that it was the mismatch of risk and reward, often caused by ill suited institutions, that resulted in financial crisis and stated that, "we should try to eliminate situations where one party makes the decisions and reaps the gains while someone else pays the costs or suffers the losses."<sup>21</sup>

#### The Real Costs of Risk Shifting

In fact, the financial risk shifting which allows an IPP to enjoy a lower cost of capital also imposes new costs on the purchasing IOU. This shifting of IPP debt risk to the purchasing utility creates a situation where IPP leverage, and the corresponding cost of capital advantage, can only occur because of an offsetting cost of capital disadvantage to the purchasing utility. According to Glen McIsaac, for the "purchasing utilities, such commitments increase financial risk exposure and result in a higher cost of capital, and higher required equity ratios."<sup>22</sup> Ikemoto and Carlow argue that, "[a] business taking both production and market risks would need significantly more equity."<sup>23</sup>

The cost of capital increase to the utility is due to an erosion in the utility's credit rating when there is a greater

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<sup>21</sup>Harry M. Markovitz "Markets and Morality" *Wall Street Journal*, May 14, 1991, p. A22. Markovitz shared the 1990 Nobel Prize in economics with William Sharpe and Merton Miller. These three are the seminal thinkers in the area of financial economics including portfolio theory and the economics of financial risk.

<sup>22</sup>McIsaac *supra* at 12-2.

<sup>23</sup>Ikemoto and Carlow *supra* at 11-3.



reliance on independent power and/or the increased need for equity in the capital structure of the utility. According to Moody's Investor Services "[g]reater reliance on purchased power, especially if costs and reliability are placed outside the utility's control, is likely to erode quality and lead to lower Moody's ratings."<sup>24</sup> Thus, "situations are likely to arise which will increase a utility's cost of capital."<sup>25</sup> The reasons for the increased cost of capital to the utility are twofold:<sup>26</sup>

If credit quality is deteriorating, the utility's overall cost of debt and equity capital will increase because of (a) the higher cost of debt that would be issued in the future, and (b) the higher risk to the equity holders because of increasing business risk.

The cost of capital advantage to an IPP is offset by a cost of capital detriment to the purchasing utility. The situation is described as a financial externality because the IPP is able to shift risks without payment.<sup>27</sup> To illustrate the concept of a financial market failure, two different scenarios need to be

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<sup>24</sup>Burke *supra* at 6,7.

<sup>25</sup>*Id.*

<sup>26</sup>Comments of Moody's Investor Services before the United States Senate Committee on Energy and Natural Resources, February 12, 1988, p. 2.

<sup>27</sup>An externality occurs when the free market fails to account for all costs and benefits in a particular transaction and therefore the actions of one economic actor affects the well-being of another. Another way of looking at this concept is to note that an externality occurs when one individual is affected adversely by the actions of another and the market fails to provide the proper compensation to the damaged party.

examined.

In the first, an independent IPP, which is a separate corporate entity, contracts to sell power to a utility. In the second, a utility sets up its own IPP, and buys power from it. In the first scenario, the independent IPP, as a separate corporate entity, enjoys a real cost of capital advantage. The associated risk costs are external to the IPP and are imposed on another corporate entity, the utility. As such, the independent IPP can make use of its cost of capital advantage and price power at a lower price, offer a higher equity return or absorb greater layers of inefficiency and still remain competitive.

In the second scenario, the utility's IPP can only produce a cost of capital advantage by imposing additional costs on the parent corporation, since the IPP and the utility are contained in one corporate entity. The associated risk costs are internal to the corporation, which has no external place to shift the risk. As such, there is no net cost of capital advantage to the corporation and it cannot price electricity at a lower price, offer a higher equity return or absorb more inefficiency.

The Financial Market Failure: Why Would IOUs Participate?

The utility suffers an artificial cost of capital detriment only if it is not compensated for the additional financial risks shifted to it by the IPP. Why would the utility bear risks it is not paid to bear? The answer to this question reveals why the situation is described as an "externality," a market failure, as opposed to a functioning free market.

In a normal market setting the IOU could bargain with the IPP or require that "external" costs be internalized as part of the bidding process. A survey of state bidding processes by the Edison Electric Institute did not show any examples of explicit attempts to account for the financial costs imposed on IOUs by third party generators.<sup>28</sup> There is no procedure to date to add the financial externality to the bid prices of IPPs or to impose equivalent capital structures. A 1989 study explicitly looked for "full cost accounting" in bidding procedures:<sup>29</sup>

Energy Management Associates, Inc. has reviewed most of the competitive bidding systems adopted by utilities across the country. None of the evaluation procedures in the bidding systems reviewed explicitly recognize the financial risks associated with commitments to purchase power from IPPs. Instead, the prices bid by independent suppliers are compared directly to the costs of traditionally financed utility construction.

Not surprising, when Delmarva Power & Light proposed including an Equity Adjustment Factor in its bid evaluation procedure to account for the detrimental effects on credit rating of using IPP power, it was vigorously opposed by the National Independent Energy Producers.<sup>30</sup>

The lack of evidence of an inclusion of the costs of risk

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<sup>28</sup>See Edison Electric Institute *Competitive Bidding in the Investor-Owned Electric Utility Industry*, July, 1990.

<sup>29</sup>Glenn P. McIsaac *supra* at 12-4.

<sup>30</sup>Letter to Daniel Grahagan of the Public Service Commission of Maryland from Robert T. Sherman, Jr., October 5, 1990.

shifting in bidding procedures proves that the financial externality exists. That costs are shifted to IOUs is indisputable. That such costs are not accounted for in any of the bidding procedures is also indisputable. For costs to be accounted for, there must be an explicit requirement in bidding procedures that either IPPs provide remuneration for contractual risk shifting, the risk costs are added to the IPP bid price for bid evaluation purposes or the IPPs are not allowed to shift risks through contract. Thus, the current and prospective relationships between IOUs and IPPs must be characterized as market failures, not competition for generation.

The existence of this financial externality has been analyzed by at least one large investment banking house. In a letter to Senator Bennet Johnston, Thomas Coughlin, Managing Director of Investment Banking for Merrill Lynch stated the following:<sup>21</sup>

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<sup>21</sup>Thomas J. Coughlin, Letter to Senator Bennett Johnston, May 3, 1991, p. 2.

To the extent that utilities take on more risk in competitively bid power purchases without obtaining offsetting rates of return, their cost of capital will increase while the NUG's cost of capital will be correspondingly reduced. The result is a hidden cross-subsidy that may produce an inefficient and uneconomic result. In a non-regulated, free market environment, it would be imprudent for an investor-owned utility to accept these risks without the prospect of a higher rate of return. Utilities do so currently because of the substantial influence that regulators have over the competitive bidding process and other utility related operations of the company, and the fact that the regulated utility also has a statutory obligation to serve which is not shared by independent power producers.

The present competitive bidding system results in a short-term subsidization of the ratepayer because the independent power producers' costs of capital and up being artificially lower than they should be, and utility stock and bond holders absorb the loss through market price depreciation associated with the utility's increased risk. Ultimately, ratepayers will cover the cost of this cross-subsidy when the utility finds that it needs to raise additional capital in the financial markets in order to finance its regular utility business and the utility's electric service rates are increased accordingly.

The financial externality is not likely to be accounted for in state bidding procedures. State PUCs may have a different planning horizon than IOUs and certainly face a different set of

incentives.<sup>2</sup> IOUs, fearful of *ex post* prudency reviews or other sanctions, could easily be compelled to purchase independent power even when such power will prove more expensive when all long-term costs are fully assessed. This does not mean that the PUC is ignorant--it merely requires that PUC officials operating in a political world with a fairly short political time horizon respond rationally and normally to the political incentives inherent in the structure of the system. After all, it is these officials who are the final arbiters of the market for generation, not the invisible hand of the free market.

This section has described the risks inherent in the electric power generation business and the way such risks would be shifted from IPPs to IOUs. It has also illustrated that the risk shifting would not be compensated creating a market failure. It is well known as a theoretical matter that externalities result in a loss of economic efficiency. An empirical analysis of the consequences of uncompensated IPP risk shifting is provided in the next section.

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<sup>2</sup>Several years ago economist James Buchanan was awarded the Nobel Prize for his research on "Public Choice." The Public Choice school analyzes the incentive structure that dictates the behavior of government officials. Politicians, for instance, that face a two year election cycle will rationaly be motivated more by short-term events than by events ten or twenty years in the future.

The same type of analysis can be directed at officials serving on public service commissions.

### III. Consequences of Uncompensated Risk Shifting

The previous section described how risks can be shifted by IPPs to IOUs without compensation. This section empirically demonstrates the consequences of this type of market failure.

#### Previous Experience with Market Failure

Unfortunately, examples abound of market distortions leading to economic inefficiency. In some cases, biases in the tax code led to an inefficient allocation of investment. In others, uncompensated risk shifting (usually due to inappropriate government action in a partially deregulated environment) led to financial crisis.

Recent history in an area outside of energy economics has pointed out that perfectly rational economic agents can be induced to make decisions that may be in their own private interests but antithetical to economic efficiency and social wellbeing. The Tax Reform Act of 1986 was landmark legislation enacted in large part because differential tax treatment was perceived as causing extreme biases in flows of investment. Tax favored investments were made to the extent that the nation's capital stock was viewed as skewed and inefficient. The tax code was believed to be producing differences in the financial costs of capital among industries resulting in over-investment in some industries and under-investment in others. These tax-induced cost of capital distortions were thought to cause losses to the

economy in the billions of dollars.<sup>33</sup> Although some observers would argue that the objective was not met, a primary goal of the 1986 Act was to reduce tax-induced cost of capital distortions so that investments were based on economic merits, not on artificial financial biases.

In the 1980s crisis existed in the financial sector. The S&L debacle and bad press about leveraged buy-outs caught the attention of policy makers. Much of the reaction took the form of mis-placed assaults on debt when in the reality, the problem was caused by partial deregulation scenarios where those that benefitted from debt did not have to face its costs. Nobel Laureate Harry Markowitz describes the 1980s' financial crisis:<sup>34</sup>

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<sup>33</sup>See, Jane G. Gravelle "The Social Cost of Nonneutral Taxation: Estimates for Nonresidential Capital" in *Depreciation Inflation & The Taxation of Income from Capital*, Charles R. Hulten, ed. (Urban Institute -- Washington, D.C., 1981), pp. 234-250; and Patric H. Hendershott and Shen-Chang Hu "Government-Induced Biases in the Allocation of the Stock of Fixed Capital in the United States" in *Capital, Efficiency and Growth*, George M. Von Furstenberg, ed. (Ballinger -- Cambridge, 1980), pp. 323-360.

<sup>34</sup>Markowitz *supra*.



The S&L structure encouraged gambling by S&L managements with S&L funds. The risks they took were in real estate and junk bonds. The game was structured so that if bets were won on average, then the S&L management gained; if the lost, then the U. S. taxpayer lost.

A similar game was available to some insurance companies. A good example is Fred Carr's First Executive Corp....The money with which Mr. Carr bought junk bonds was mostly the reserves of insurance policyholders. As with S&Ls, Fred Carr bore little of the risk of the junk bonds. The risk was principally borne by the policyholders, who were not warned of this risk...

The chief complaint about Wall Street in the 1980s was not about lawbreaking, but about highly leveraged hostile takeovers. I now hold the hypothesis that excesses in this area were primarily due to the availability of large pools of money whose ultimate owners or guarantors could be stuck with risk with little or none of the reward, without their knowledge or consent. [emphasis added]

The externality discussed in this paper contains elements of both of these 1980s economic distortions. The uncompensated risk shifting results in a situation where those making decisions, IPP managements, do not bear the complete risk of those decisions, and this is exacerbated by the artificial tax bias in favor of debt and against equity.

### Empirical Analysis of Risk Shifting Implications

This section will demonstrate the extent to which there would be an artificial competitive bias in favor of IPPs under existing bidding systems. The procedure is to model important financial variables for existing IOUs and potential IPP developers. Actual corporations are used in the simulations. Potential IPP developers include pure independents such as Long Lake Energy

Corporation and IOU subsidiaries desirous of operating in other service territories. The technical details of the analysis are described in the Appendix to this paper.

The empirical analysis has four steps. The first is to isolate the purely financial aspects of uncompensated risk shifting by calculating the relative discount rates for IPPs and IOUs. The next step is to use standard investment criteria to show how generation investment will be biased in favor of IPPs. The required annual cash flows for IPPs and IOUs will be calculated assuming identical facilities and cost efficiencies. This will show how IPPs can systematically underprice IOUs. The next experiment calculates the maximum equity return an IPP could offer and still remain price competitive, assuming identical facilities and efficiencies. The economic literature points out that when there are artificial biases, economic inefficiency often results. The final experiment relaxes the assumption of equal efficiency and simulates the maximum additional cost inefficiency an IPP could display and still remain price competitive while paying equity holders their hurdle rates. For these simulations a sample of real companies were chosen. The sample includes seven potential IPPs and nine existing IOUs.

#### The Weighted Average Cost of Capital

The first step in the analysis is to describe how the uncompensated risk shifting and the tax advantage to debt results in a systematic cost of capital advantage for IPPs in all but the most trivial of examples. The standard financial representation

of the cost of capital is the Weighted Average Cost of Capital (WACC). The WACC is the minimum rate of return on an after-corporate-tax cash flow that an investment must yield to compensate debt and equity holders for putting capital at risk. It provides the basis for the discount rate that corporations apply to after-tax cash flows when evaluating investment opportunities. By definition, the WACC is the weighted average of the required returns to debt and equity holders. As such it incorporates the risk premiums inherent in the required returns.

Conventional corporate finance analysis calculates both before-tax cash flows and income taxes as if the investment were financed purely with equity. The discount rate (WACC) used to discount the after-tax cash flow, however, reflects the deduction of interest expense. Thus, both relative risk and the tax advantage of debt are reflected in the WACC. A comparison of the WACCs for IOUs and IPPs in real world situations should shed light on the question of a cost of capital advantage for IPPs. Required debt rates, equity hurdle rates and capital structures are required for the comparison.

#### *IPP versus IOU Debt Rates*

All analysts would agree that, all else held constant, debt is less expensive than equity due to the tax advantage of the former. The Senate Staff report, previously cited, puts the issue in the proper analytical context:<sup>35</sup>

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<sup>35</sup>Conway/Hausker *supra* at 2.

If one could hold all else equal, as a business used more debt, its cost of capital would decrease. In the real world, however, one cannot hold all else equal. If a business takes on more debt, this tends to: 1) increase the risk of defaulting on debt payments, and 2) increase the uncertainty and variability of returns to equity. This drives up the cost of both debt and equity, and thus drives up the overall cost of capital.

As confirmed in any standard graduate level financial economics text, the optimal capital structure occurs "when the present value of tax savings due to additional borrowing is just offset by increases in the present value of the costs of distress."<sup>24</sup> The previous section has described the financial risk shifting and the low level of risk premium in IPP debt rates. Because of the risk shifting, IPPs can employ high levels of debt and enjoy relatively low interest rates. IPP and IOU debt interest rate assumptions are described in the Appendix and reported in Table 1 for the companies in the sample.

#### *IPP vs. IOU Equity Hurdle Rates*

Many proponents of PUHCA changes argue that there is no inherent cost of capital advantage to IPPs because whatever tax advantage for debt exists may be wiped out by the higher equity returns required by IPPs. This is somewhat curious. One wonders why, if the market is aware that IPP debt is not terribly risky due to the purchase power contract, the market would not apply

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<sup>24</sup>Richard A. Brealy and Stewart C. Myers *Principles of Corporate Finance* (New York: McGraw-Hill, 1988), at 421.

the same logic to equity. After all, the same stable revenue stream exists for shareholders as for those holding debt. In fact the market does apply the same logic.

Financial analysts have a methodology to measure the risk associated with investing in the equities of various companies.<sup>37</sup> It is interesting to compare one of the more aggressive independent power developers with other U. S. corporations that are placed in an identical risk category to this IPP developer. The company in question is the Long Lake Energy Corporation. The market considers Long Lake's equities to have identical risk to those of Sherwood Williams, Co.; Xerox Corp.; Maytag Corp.; Westinghouse Electric Corp. and Du Pont E. I. De Nemours & Co.<sup>38</sup> These are not exactly high risk operations. In fact the securities of these companies are only slightly more risky than the Standard & Poor's 500 Index as a whole.

In general IPP equity will be fairly mainstream in terms of risk analysis. This is especially true when IPPs are wholly owned subsidiaries of blue-chip corporations. Of course it is large companies such as Long Lake and utility subsidiaries that

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<sup>37</sup>The methodology is known as the Capital Asset Pricing Model (CAPM). Last year the developer of the CAPM received the Nobel Prize in Economics. CAPM measures a company's required equity return as the sum of a relevant risk free rate of return plus a risk premium. The risk premium, in return is defined as a function of the variable beta which measures the systematic risk of a company's equities relative to the stock market as a whole. Comparing different company's betas provides a way of gauging the relative risks and required equity returns of various companies.

<sup>38</sup>Based on beta calculations in Merrill Lynch "Security Risk Evaluation" March, 1991 at 68,69. All of the cited companies have betas of 1.17.

would be the most likely IPP developers if PUHCA changes are made. There will be precious few start-up IPPs.

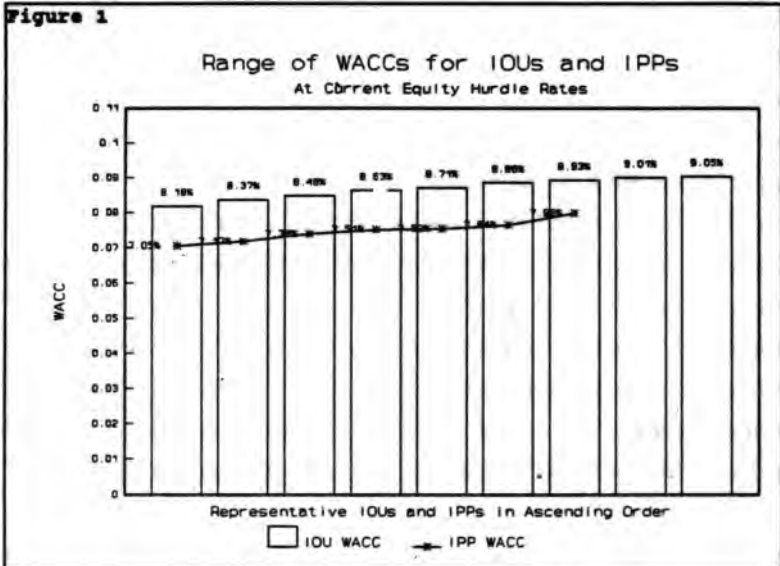
Equity hurdle rates are measured as the sum of a risk free rate of return plus a risk premium as described in the Appendix. Table 1 (at the end of the main report) displays equity hurdle rates for the sample IOUs and IPP developers under existing conditions. In all likelihood, the hurdle rates for IPPs will be considerably lower in a post PUHCA-change world than those reported for pure independents in Table 1.<sup>39</sup> This is because the existing hurdle rates are based on current competitive and political conditions. They are essentially the returns an equity investor would demand to invest in a company that produces independent power under PURPA or the required return on an investment in a company that may be able to expand if PUHCA changes become law. There is considerable risk under PURPA that expansion is reaching its limits and enormous political uncertainty about the development potential for purely independent power not constrained by PURPA or PUHCA. If PUHCA changes became law both of these sources of risk would disappear and hurdle rates would diminish rapidly. This is the expectation of rating agency executives and investment bankers.

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<sup>39</sup>The hurdle rates for IOU subsidiary IPP developers are based on published \$s for the IOU parents and might be low relative to a post PUHCA-change world. (See the Appendix.) Should the parent become heavily involved in IPP development, the hurdle rates may rise to somewhere between the IOU rates and the rate for a true independent such as Long Lake.

### The WACC Calculation

Table 1 also displays the WACCs for the nine IOUs and seven potential IPP developers. Figure 1 shows the range of WACCs for IOUs and IPPs graphically.



As can be seen, in every case the IPP's WACC is substantially lower than the IOU's. For the IOUs, FPL Group, Inc. is representative of a typical utility, falling somewhere in the middle for equity hurdle rates.<sup>40</sup> In the rest of this paper FPL will be compared to representative IPP developers. FPL's WACC is 9 to 24 percent higher than the potential IPP developers listed.

<sup>40</sup>See Appendix note 4.

Note that even with an equity hurdle rate of 21.46 percent, Bonneville Pacific Corporation has a lower WACC than all of the listed IOUs.

The gulf between IOU and IPP WACCs is probably larger than that displayed in Table 1. First, the IPP equity hurdle rates will be lower after PUHCA changes. Second, the Table assumes a 100 basis point difference between IPP and IOU debt interest rates which is the upper bound for IPP risk premiums--especially for large IPP developers. Based on the bond ratings for the listed IPP developers, IPP debt interest rates will be close to IOU rates.<sup>41</sup>

#### Required Annual Cash Flow

The WACC provides the basis for judging the effects of uncompensated risk shifting and tax biases but the analysis must be extended to illustrate the way in which the artificial bias will skew investment in electric generating facilities. This is done by conducting a cash flow analysis based on standard investment criteria.

Mainstream financial analysis uses the Net Present Value criterion (NPV) to judge the efficacy of investment opportuni-

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<sup>41</sup>Conversations with rating agency executives and investment banking houses confirms that the IPP-IOU debt rate differential is between 50 and 100 basis points, currently. These differentials will decrease in a post Title XV world where large companies become the major IPP developers. Consider Duke/Fluor Daniel as a potential IPP developer. In this partnership Duke Power Company has a Aa2 bond rating and Fluor Corporation has an A3 rating, better than most IOUs. If this partnership were to develop IPP projects with guaranteed minimum capacity payments, the debt interest rates would be virtually identical to an IOU's rates.



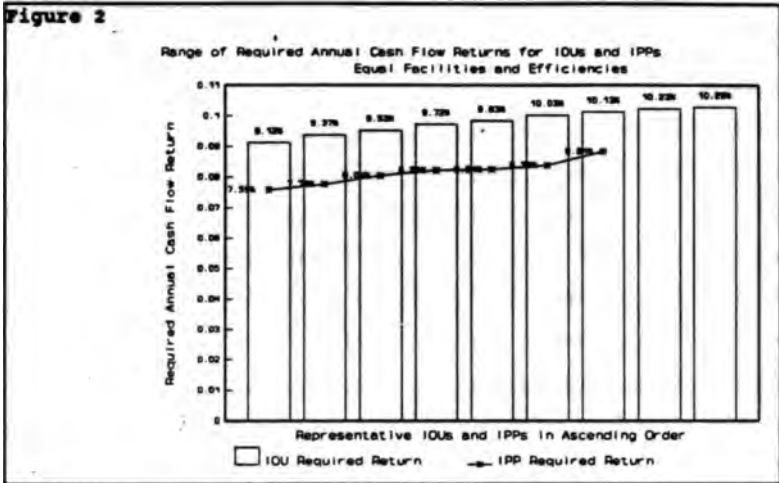
ties. After-corporate-tax cash flows associated with a potential investment are discounted by the WACC to produce the present value of the income stream. If this present value is equal to or exceeds the cost of the project (i. e. NPV is positive), then the investment is a good one.

The minimum annual cash flow necessary to produce a positive NPV is the required annual return. This cash flow is that which is necessary, expressed as a percentage of project cost, for the company to pay corporate taxes, cover any capacity decay or obsolescence, service its debt and pay equity holders at least their hurdle rate of return. A company will calculate its required annual return and compare it to projections of project cash flow. Those projects where projected cash flow exceeds required cash flow will be undertaken.

A cash flow model was developed to compare required annual returns for IPPs to those for IOUs. (See the Appendix.) In the initial experiment it was assumed that IPPs and IOUs had identical operating and construction efficiencies and were considering investments in identical combined-cycle facilities. All non-capital costs were assumed to be the same.

Given these assumptions, differences in the required annual returns for IPPs and IOUs would indicate the magnitude of the artificial bias in favor of IPP investment in generating facilities. Table 2 at the end of the paper provides the numerical results and Figure 2 displays them graphically.

In Figure 2 the ranges for the seven IPPs and nine IOUs show



the magnitude of the artificial bias. Using FPL as a representative IOU, if FPL were competing for the construction of a combined-cycle facility with a company similar financially to CMS, FPL's required annual return would be 27 percent higher than CMS's. If FPL were competing with Long Lake, FPL's annual net cash flow requirement would be 20 percent higher than that of Long Lake. In general IOUs could require annual returns 20 to 30 percent higher than IPPs based on current equity hurdle rates. In a post-PUHCA change world, the likely gulf in required annual returns would be even higher as IPP equity hurdle rates dropped.

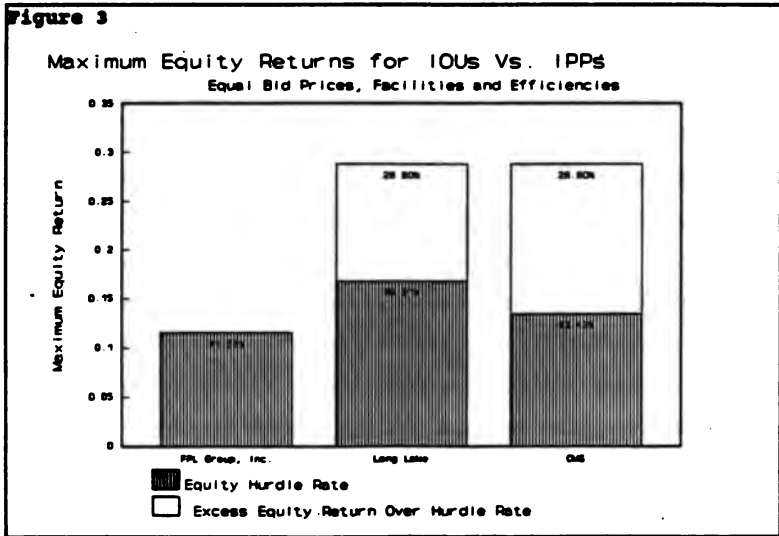
Even with a current equity hurdle rate of 21.46 percent, Bonneville Pacific Corporation would have a 3 percent required return advantage over the IOU with the lowest required cash flow in the sample--Baltimore Gas & Electric.

Of course lower required cash flows mean that IPPs will win every bid because they can offer artificially lower energy and capacity prices. For example, consider what the price advantage would be if IPPs priced power so that equity holders were just earning their current hurdle rates (e. g. about 17 percent for Long Lake and 18 percent for Hudson Power Systems, Inc.). If capital costs are 20 to 40 percent of the per kilowatt hour price, then IPPs enjoying a 20 to 30 percent artificial required return advantage could price electricity 5 to 10 percent cheaper at current equity hurdle rates. Thus, an artificial cost of capital advantage creates a situation where IPPs will be able to systematically underprice IOUs. Of course, it is not the case that IPPs will price at the bare minimum. Other possibilities are examined in the next sections.

#### Maximum Equity Return for IOUs and IPPs

In this experiment it is assumed that the IPP and the IOU are bidding on identical combined-cycle facilities and have identical construction and operating cost structures. The IPP may decide to exploit its artificial capital cost advantage by paying equity holders well in excess of their hurdle rates of return. The maximum equity return an IPP could pay is slightly less than that which would require the IPP to bid an identical price to the IOU. This latter equity return is calculated here. The experiment uses FPL as the representative IOU and calculates the maximum equity return any IPP could offer and still bid an equivalent price. Then this maximum rate is compared to the

existing hurdle rates for two potential IPP developers--Long Lake and CMS. Table 3 shows that CMS could offer equity rates 15.37 percentage points in excess of its current hurdle rate (more than twice the current hurdle rate) and Long Lake could offer an equity return that is 12 percentage points higher than current hurdle rates (1.7 times the current hurdle rate). The maximum equity return an IPP could offer its shareholders and still remain price competitive with FPL is 28.8 percent. This is shown graphically in Figure 3.



The consequences of the ability of IPPs to offer substantially higher equity rates are significant. It will be very difficult for IOUs to attract equity capital, not because they are not financially sound but because IOUs and U. S. taxpayers

are subsidizing the IPP equity holders' returns.

#### Potential IPP Inefficiency

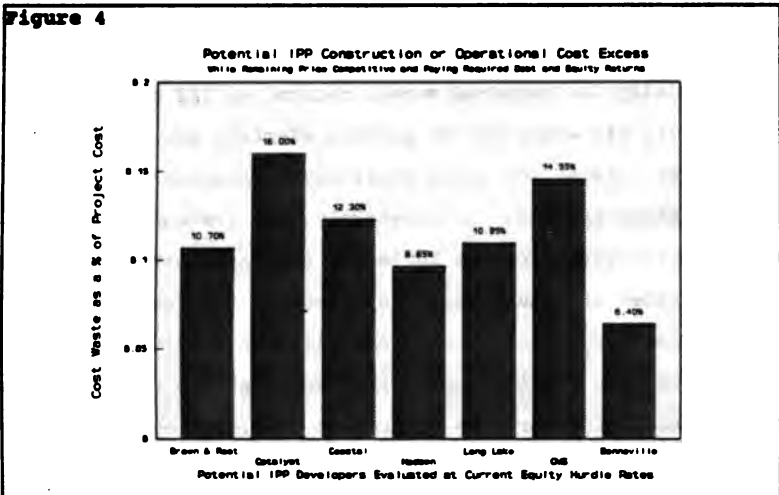
Market failures result in economic inefficiency. Subsidies allow companies that normally would not be competitive to win bids despite their shortcomings. In a post-FURCA change world, companies will enter the market until the last one can just pay its required rates of return to capital holders and still price competitively. Given a substantial capital subsidy, a less efficient firm will still be able to attract capital and remain price competitive.

What forms would inefficiency take? To the extent that an IPP might be at risk for construction cost escalations, the artificial financial cushion will give it less of an incentive to discipline contractors. It may be able to absorb greater construction delays. Similarly, it could absorb greater operating inefficiency whether that takes the form of resource wastage, inefficient decisions or bloated management salaries or perks.

This final experiment assumes that the IPP and IOU are bidding for identical combined-cycle facilities and that each must pay their equity holders current hurdle rates of return. The experiment calculates the maximum inefficiency or wastage, relative to the IOU, an IPP could display and still be price competitive. This waste could take any of the forms cited above or others. It is expressed as a lump sum equal to a percentage of original project costs. As explained in the Appendix, the simulations capture inefficiency in the variable  $\Omega$  defined to be

a percentage of project cost. For example, if the simulation finds that the  $\Omega$  for an IPP is 10 percent, than that IPP could withstand construction cost overruns that are 10 percent of the total construction cost, pay debt and equity holders their required returns and still remain price competitive in bidding.

In this experiment, FPL remains the representative IOU. Table 4 displays the potential waste for the seven IPPs in the sample. Figure 4 depicts the situation graphically.



The implication is not that these corporations will be less efficient than FPL but that they could be. The financial subsidy of the IPP removes an important source of cost discipline. Because risks are shifted without cost to the IOU and because of the tax advantage to debt, the IPP is cushioned to the point where it could become quite careless and still remain competi-

tive. For instance Long Lake Energy Corporation could enter a competitive bid against FPL Group for a combined-cycle facility safe in the knowledge that even if management made mistakes, they could absorb cost overruns of up to 11 percent of project cost (an option not open to FPL) and still keep their shareholders happy.

#### Conclusion to the Empirical Analysis

The artificial cost of capital advantage to the IPP that results from uncompensated risk shifting and the tax advantage to debt can take three forms or a combination of the three. Due to the artificially low required annual return, an IPP could systematically win every bid by pricing electric power 5 to 10 percent lower than an IOU while still paying shareholders their required minimum returns. Alternatively, the IPP could price electric power just below the IOU's bid and pay equity holders exorbitant rates of return, well in excess of the required minimum. Finally, the artificial capital cost subsidy could encourage economic inefficiency. IPPs could absorb cost overruns that are substantial portions of project cost, pay equity holders their hurdle rates and still price electric power just under an IOU's bid.

# **Table 1** **Weighted Average Cost of Capital** **Using the Capital Asset Pricing Model**

IPP	Debt	Equity
10.00%	90.00%	10.00%
50.00%	50.00%	50.00%

Risk Free Rate of Return =	8.03%	1990 10 Year zero coupon Treasury bond rate
Market Risk Premium =	7.50%	Calculated by Ibbotson Associates

Company	Beta	Equity Hurdle Rate	Debt rate	Cost of Capital
<b>Potential IPP Developers</b>				
Brown & Root Energy Development	1.2	17.03%	10.80%	7.83%
Catalyst Energy Development	0.56	12.16%	10.80%	7.06%
Coastal Power Production Company	1	15.53%	10.80%	7.39%
Hudson Power Systems, Inc.	1.34	18.03%	10.80%	7.84%
Long Lake Energy Corporation	1.17	16.81%	10.80%	7.61%
CMR Generation	0.72	13.43%	10.80%	7.17%
Bonneville Pacific Corporation	1.79	21.43%	10.80%	7.06%
<b>Investor Owned Utilities</b>				
Baltimore Gas & Electric	0.93	10.51%	9.80%	8.18%
General Public Utilities corporation	0.53	12.01%	9.80%	8.93%
New England Electric System	0.91	11.96%	9.80%	8.66%
Northern States Power Company	0.46	11.41%	9.80%	8.53%
Public Service Company of New Mexico	0.55	12.16%	9.80%	9.01%
Carolina Power & Light	0.41	11.11%	9.80%	8.46%
Central & Southwest Corporation	0.36	10.86%	9.80%	8.37%
Commonwealth Edison Company	0.56	12.23%	9.80%	9.06%
FPL Group, Inc.	0.47	11.86%	9.80%	8.71%

Debt rates are representative and the 100 basis point difference between IOU and EWG rates illustrates the high end for debt risk premiums.

Betas from Merrill Lynch, March 1991



Table 2

# Required Annual Return Comparison

## Financial Cost of Capital Basis

Combined-cycle Technology Facility

Corporate Tax Rate	38.30% (Includes State and Local Taxes)
Property Tax Rate	1.55%
Inflation Rate	4.00%
Economic Depreciation Rate	5.60%

### Company

**Potential IPP Developers**  
 Brown & Root Energy Development  
 Catalyst Energy Development  
 Coastal Power Production Company  
 Hecdon Power Systems, Inc.  
 Long Lake Energy Corporation  
 CMS Generation  
 Bonneville Pacific Corporation

**Investor Owned Utilities**  
 Baltimore Gas & Electric  
 General Public Utilities corporation  
 New England Electric System  
 Northern States Power Company  
 Public Service Company of New Mexico  
 Carolina Power & Light  
 Central & Southwest Corporation  
 Commonwealth Edison Company  
 FPL Group, Inc.

### Required Annual Return

8.24%  
 7.58%  
 8.04%  
 8.39%  
 8.21%  
 7.76%  
 8.84%  
  
 8.12%  
 10.13%  
 10.03%  
 9.72%  
 10.23%  
 9.52%  
 9.37%  
 10.28%  
 9.63%

Table 3

# Maximum Equity Return an IPP Could Offer And Still Beat IOU Bid

Combined Cycle Technology Facility

Required Annual Return	FPL Group, Inc.	IPP
	9.83%	9.83%
Equity Return		10.50%
Debt Rate	9.50%	10.50%
W. A. G. G.	8.71%	8.71%

## Excess Return Over Hurdle Rate Long Lake CMS

12.00% 15.37%

Table 4

# Amount of Inefficiency an IPP Could Exhibit And Still Be Competitive With an IOU Bid

Combined-cycle Technology Facility  
(Inefficiency expressed as a % of Total Project Cost)

Corporate Tax Rate	38.30% (Includes State and Local Taxes)
Property Tax Rate	1.55%
Inflation Rate	4.00%
Economic Depreciation	5.60%

## Company

### Potential IPP Developers

Brown & Root Energy Development  
Catalyst Energy Development  
Coastal Power Production Company  
Hudson Power Systems, Inc.  
Long Lake Energy Corporation  
CMS Generation  
Bonneville Pacific Corporation

### Representative IOU

FPL Group, Inc.

## Inefficiency Factor      Required Annual Return

10.70%	9.53%
16.00%	9.53%
12.30%	9.53%
9.65%	9.53%
10.85%	9.53%
14.55%	9.53%
6.40%	
	9.53%

## APPENDIX

### *Technical Aspects of Required Return Simulations*

#### Introduction: The Basic Model

This appendix describes the technical details of the model used to perform the simulations reported in the main body of the report. The basic model must be able to calculate the required annual returns that must be earned by an IOU or an IPP for an investment in an identical generating facility. For purposes of this analysis it is assumed that the investment being considered is in a combined-cycle facility of identical capacity and technical specifications for both the IOU and the IPP.

The basic model is capable of being manipulated to answer three questions: (1.) What is the minimum annual required return for the IPP and the IOU given identical facilities and operating and construction efficiency but different capital structures and hurdle rates for equity as well as different required debt rates? (2.) Given identical facilities and efficiencies but different capital structures and debt interest rates, what is the maximum equity return an IPP could offer and still produce a bid price competitive with an IOU? (3.) Given identical planned facilities but different levels of construction or operating efficiency, different capital structures, different equity hurdle rates and different required debt interest rates, how inefficient could an IPP be and still produce a bid price competitive with an IOU?

APP-1

### A Cash Flow Approach

The required annual return is the cash flow, expressed as a percentage of project cost, that the facility must return in order for the company to pay its taxes, cover any capacity decay, service its debt and pay at least the minimum required rate of return to equity holders. Economists refer to this required cash flow as the "financial cost of capital" which is influenced by the Weighted Average Cost of Capital (WACC) but is not the same thing.<sup>4</sup> The starting point of the analysis is the microeconomic theory of the firm and the Net Present Value (NPV) criterion for investment. When all positive and negative cash flows are accounted for, a firm will make an investment only if the present value of the after-tax income stream is at least as great as the cost of the facility. At the margin, in equilibrium, the present value of the income stream will just equal the asset cost.

Most economists prefer to describe their cash flow models in continuous time. The model employed here is based on the standard derivations as modified to take explicit account of risk and differing equity hurdle rates of return. The model was designed primarily by former Assistant Secretary of the Treasury Don

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<sup>4</sup>The WACC is simply a weighted average of the firm's required payments to debt and equity holders. The WACC forms the basis of the firm's discount rate which is used to discount all after-corporate-tax cash flows. The financial cost of capital is the minimum cash flow, discounted by the WACC, after accounting for all corporate tax factors and economic depreciation.

Fullerton.<sup>6</sup> Although other variations on this theme exist, the Fullerton methodology is generally accepted and widely used.

The Fullerton model is a cash flow model with asset cost on the left hand side and income flows on the right hand side. Equation (1) states the firm's equilibrium condition as it applies to a new investment in electric generating capacity:

$$q = \int_0^{\infty} (1-\tau) (c-wq) e^{(n-\delta)t} e^{-\delta(1-\tau)t} dt + \tau Zq \quad (1)$$

Where

- $q$  = the price of a new generating facility;
- $\tau$  = the corporate tax rate (including state and federal taxes);
- $Z$  = the present value of depreciation deductions per dollar of investment;
- $w$  = the rate of local property tax on electric utilities (deductible against state and federal income taxes);
- $\pi$  = the inflation rate;
- $\delta$  = the rate of economic depreciation (including capacity decay and obsolescence);
- $c$  = the gross required income return per year (gross of

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<sup>6</sup>For a description of the methodology see Don Fullerton "The Indexation of Interest, Depreciation, and Capital Gains and Tax Reform in the United States," *Journal of Public Economics*, February 1987, pp. 25-51 and Don Fullerton and Yolanda K. Henderson, A Disaggregated Equilibrium Model of the Tax Distortions Among Assets, Sectors, and Industries," *International Economic Review*, May 1989.

tax but net of operating and maintenance costs);  
and

$i$  = the corporate nominal pre-tax discount rate which is determined with reference to the Capital Asset Pricing Model (CAPM).

Equation (1) is a short-hand representation of a "permanent reinvestment" model. A company would not allow a facility under normal circumstances to decay to nothing, but would reinvest to maintain the capacity and value of the unit. A permanent reinvestment model explicitly incorporates reinvestment in each period at a rate  $\delta q$  to maintain the value of the facility. Jane Gravelle has shown that if a firm can make use of all tax shields, then the reinvestment terms and accompanying tax terms drop out of the equation to produce an expression identical to equation (1).<sup>44</sup>

In equation (1),  $c$  and  $i$  are unknown.  $c$  is the per period cash flow necessary to cover all taxes, economic depreciation and required returns to debt and equity holders as captured in  $i$ . Once  $i$  is determined,  $c$  can be solved for, given an assumed inflation rate and knowledge of all relevant tax systems.

#### User Costs and Financial Costs

The literature refers to  $c$  as the "user cost of capital" or the "implicit rental price" of capital. The variable to be compared in this analysis is the required net-of-economic-depre-

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<sup>44</sup>See Jane Gravelle and Gregg A. Eskinwein, "The Measurement and Interpretation of Effective Corporate Tax Rates: A Comment" *Tax Notes*, June 6, 1983.

ciation return which is known in the literature as the financial cost of capital. The financial cost of capital is simply the user cost less the required cash flow to make up for economic depreciation (to cover replacement investment). Since "like" facilities are being considered in this analysis, the financial cost of capital is the appropriate measure of a required annual return. The user cost of capital is derived by evaluating equation (1) and solving for  $c$ :

$$c = \frac{q[i(1-\tau)-\pi+\delta]}{1-\tau} (1-\tau Z) + wq \quad (2)$$

The financial cost of capital,  $c_f$ , is the following:

$$c_f = \frac{c}{q} - \delta \quad (3)$$

### Determination of the Corporate Discount Rate

The next step in the analysis is to account for the unknown  $i$ . This is a crucial step because this variable incorporates different capital structures and required returns to debt and equity, as well as the tax advantage of debt. In Fullerton's analysis, the discount rate was determined by setting a real after-corporate after-personal-tax required return to an individual investor by assumption and then grossing it up by the relevant tax terms to produce the corporate discount rate. This was appropriate because Fullerton was measuring the effects of personal and corporate tax changes on a firm's financial cost of



capital. There was no accounting for risk or differing hurdle rates of return in the analysis.

For purposes of this analysis, an explicit accounting of risk and the resultant differences in debt interest rates and equity hurdle rates is necessary. Accordingly, the Capital Asset Pricing Model (CAPM) is used to produce after-corporate tax discount rates,  $i(1-r)$  in equation (1), for IPPs and IOUs. The discount rate will be denoted  $r_{app}$  and is equal to  $i(1-r)$ .

The revised expression for the financial cost of capital will be:

$$C_f = \frac{[r_{app} - \pi + \delta]}{1 - \tau} (1 - \tau Z) + w - \delta \quad (4)$$

#### The Weighted Average Cost of Capital

The WACC is the minimum rate of return on an after-corporate-tax cash flow that an investment must yield to compensate debt and equity holders for putting capital at risk. Conventional corporate finance analysis calculates both before-tax cash flows and income taxes as if the investment were financed purely with equity. The discount rate used to discount the after-tax cash flow, however, reflects the deduction of interest expense. Thus, the tax advantage to debt is reflected in the WACC. Capital structure is also reflected in the WACC which is the weighted average of the cost of equity and the after-tax cost of debt:

$$WACC = r_{wacc} = \omega_e r_e + \omega_d r_d (1 - \tau) \quad (5)$$

where

$r_e$  = the required return to equity;

$r_d$  = the debt interest rate;

$\omega_e$  = the portion of equity in the capital structure;

and

$\omega_d$  = the portion of debt in the capital structure.

#### CAPM and the Equity Hurdle Rate

CAPM is widely used to determine a company's equity hurdle rate. The hurdle rate,  $r_e$ , is stated as the sum of a risk-free rate of return plus a risk premium. The risk premium, in turn, is a function of the company's  $\beta$  which relates the performance of a company's equities to the stock market as a whole. Thus,  $\beta$  is the systematic measure of risk. A  $\beta$  of 1 indicates that a company's equities embody the same risk as the stock market as a whole. A  $\beta$  of, say, 2 would indicate a company with considerable risk and it would be expected that the company's equity hurdle rate would contain a substantial risk premium. The actual risk premium is calculated to be the product of  $\beta$  and the general market risk premium (for the stock market as a whole). The equity hurdle rate is defined as:

$$r_e = r_f + \beta_{equity} [r_m - r_f] \quad (6)$$

where

$r_f$  = the risk free rate of return; and

$r_m$  = the rate of return on the stock market as a whole.

The risk free rate of return is the rate an investor could earn on a riskless investment such as a Treasury security of appropriate term. The choice of a riskless rate is discussed in the data section as is the market rate of return and the proper  $\beta$ s for IPPs and IOUs.

#### The Relevant Debt Interest Rate

The interest rate for IOUs is stated after an observation of existing IOU interest rates. It has been stated by rating agency executives and investment bankers that with the expected contractual arrangements, IPP debt rates would be 50 to 100 basis points higher than IOU debt. For this analysis, IPP interest rates are assumed to be 100 basis points higher than IOU rates.

#### Three Questions

The introduction to this appendix listed three questions that are the focus of the quantitative analysis. This section describes the experiments performed to answer these questions.

#### Required Annual Return

$c_i$  is calculated for 7 potential IPP developers and 9 existing IOUs. The IPPs are a mix of utility subsidiaries and pure independents. The differentials in  $c_i$ s provide a direct quantification of the artificial cost advantage of uncompensated risk shifting and the tax advantage of debt.

#### Maximum IPP Equity Return

For purposes of this experiment it is assumed that IPPs and IOUs have identical operating and construction efficiencies and that all non-capital costs are equal. Defining a competitive bid

as the situation where IPP energy and capacity charges are just equal to or lower than those associated with an IOU, an IPP can offer an equity return up to the point where IPP and IOU capital costs are just equal. This occurs when  $c_i$  (and  $r_{app}$ ) are the same for the IOU and the IPP.

FPL Group, Inc. is chosen as a representative IOU.<sup>4</sup> Holding all else constant, the equity return for an IPP is calculated as a residual such that FPL's  $r_{app}$  just equals that of the IPP. This maximum equity return is then compared to the hurdle rates for two potential IPP developers, Long Lake and CMS Generation, to estimate the extent to which uncompensated risk shifting in combination with the tax advantage to debt produces equity returns in excess of those necessary to compensate investors for the risk inherent in IPP securities under current situations.

#### Potential Cost Inefficiency

In this experiment it is assumed that the IPP must bid prices that are just equal to or lower than an IOU's prices. Assuming identical facilities, the experiment calculates the extent to which an IPP could be less efficient than an IOU and still pay investors at least current hurdle rates while offering a competitive bid.

In this case inefficiency could take several forms. Through delays or cost overruns, construction could be more costly for

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<sup>4</sup>FPL's capital costs are in the mid to high range for IOUs. Its  $r_i$  is 11.56 percent and its  $r_{app}$  is 8.71 percent. Thus the choice of FPL is a conservative one for comparison with an IPP.

IPPs. Alternatively, operation of capital in place could be less efficient or reliable, requiring capital redundancy. To model those possibilities, additional inefficiency is stated as a percentage of facility cost (referenced to the IOU's facility cost) and captured in the variable  $\Omega$ . To capture the potential inefficiency at a competitive equilibrium, equation (1) is restated for IPPs as follows:

$$q = \int_0^{\infty} (1-\tau) (c-wq) e^{-(r_{\text{cost}}-\tau+\delta)t} dt + \tau Zq - \Omega q \quad (7)$$

Where

$\Omega$  = the maximum inefficiency, stated as a percentage of the original IOU facility cost,  $q$ .

Evaluating equation (7) and applying algebra and noting equation (3), an IPP's required return becomes:

$$C_{I(IPP)} = \frac{[r_{\text{cost}(IPP)} - \tau + \delta] (1 - \tau Z + \Omega)}{1 - \tau} + w - \delta \quad (8)$$

The solution for  $\Omega$  occurs where  $C_{IPP} = C_{IOU}$ . As in the previous experiment, FPL Group, Inc. is used as the representative IOU.  $\Omega$ s for the seven potential IPP developers are calculated.

## Data

### Economic Depreciation

The economic value of investment (which declines because of obsolescence and capacity decay) is assumed to decline at a geometric rate as per the literature. Stand-alone gas-fired

turbines have been estimated to have decay rates of 7.86 percent per year in research by Hulten and Wykoff.<sup>46</sup> The geometric rate for combined-cycle steam generators comes from an extrapolation based on Hulten and Wykoff and information provided by the Congressional Research Service.<sup>47</sup> The assumed annual decay rate,  $\delta$ , is 5.6 percent per year.

### **Taxes**

Information on state and federal corporate income taxes is based on the National Bureau of Economic Research TAXSIM model as reported in papers by Fullerton.<sup>48</sup> The corporate tax rate (including state and federal taxes) comes from two sources.<sup>49</sup> From these sources,  $\tau$  is set at 38.3 percent. The property tax rate on utilities also comes from Fullerton.<sup>50</sup>  $\pi$  is 1.55 percent. The inflation rate,  $\pi$ , is assumed to be 4 percent per year.

The tax depreciation treatment is crucial to the financial cost of capital calculation. Under the 1986 Tax Reform Act, assets are assigned to a depreciation class based on their Asset Depreciation Range (ADR) class lives. Stand-alone gas-fired

<sup>46</sup>Charles R. Hulten and Frank C. Wykoff "The Measurement of Economic Depreciation" in *Depreciation, Inflation, and the Taxation of Income from Capital*, Charles R. Hulten - ed. (Urban Institute-Washington, D. C., 1981) at 95.

<sup>47</sup>*Id.* and Jane Gravelle, unpublished capital stock proportions and capacity decay rates. Congressional Research Service 1984.

<sup>48</sup>Fullerton *supra* at 31, 32.

<sup>49</sup>Merlyn A. King and Don Fullerton, *The Taxation of Income from Capital* (University of Chicago Press -- Chicago 1984), p. 204 and Fullerton *supra* at 31.

<sup>50</sup>Fullerton *supra* at 31.

turbines are assigned to ADR class 49.15 which has a 20-year class life.<sup>31</sup> The actual tax depreciation life is, therefore, 15 years.<sup>32</sup> If a gas turbine is used as part of a combined-cycle facility, however, the entire facility is contained in ADR 49.13. This class has a 28-year life, resulting in an actual tax depreciation life of 20 years.<sup>33</sup> For stand-alone turbines and combined-cycle facilities the 150 percent declining balance method of depreciation is used.<sup>34</sup>

The proper discount rate for depreciation deductions is not the same as the discount rate used to discount other cash flows. This is because tax depreciation deductions are fixed at the time an investment is made and therefore are associated with less risk, assuming the firm is and will continue to be taxable. Depreciation deductions are typically discounted at a debt rate, rather than an equity rate. The appropriate debt rate is the rate a company could earn on an investment grade corporate bond with cash flows of similar certainty to the depreciation deductions. This analysis discounts depreciation deductions at the rate of 10 percent.<sup>35</sup> Table A1 displays the depreciation deduc-

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<sup>31</sup>1989 Depreciation Guide, Commerce Clearing House 1989, p. 104.

<sup>32</sup>Internal Revenue Code, Sec. 168(e)(1), Sec. 168(c)(1).

<sup>33</sup>1989 Depreciation Guide *supra* and Internal Revenue Code *supra*.

<sup>34</sup>Internal Revenue Code, Sec. 168(b)(2)(A).

<sup>35</sup>See Richard A. Bresley and Stewart C. Myers, *Principles of Corporate Finance* (McGraw-Hill/New York, 1988) at 455-459. In the  
(continued...)

tion cash flows and the present value calculation per dollar of new investment in a combined cycle facility. This is the value for  $z$  in the calculation of  $c_i$ .

#### CAPM Data

$r_i$  in  $r_{\text{cap}}$  is based on a 10 year, zero coupon Treasury bond rate in 1990 and set at 8.03 percent. The overall market risk premium,  $r_m - r_i$ , is calculated by Ibbotson Associates to be 7.5 percent. As for the representative companies come from Merrill Lynch.<sup>56</sup>

#### Debt Rates

A survey of bond ratings and associated interest rates leads to the observation that IOU debt rates were as low as 9.28 percent and as high as 10.45 percent in 1990. Early 1991 rates fell in the middle of that range.<sup>57</sup> Accordingly, IOU debt rates,  $r_d$ , are assumed to be 9.5 percent for purposes of these experiments. A high end risk premium of 100 basis points is assumed

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<sup>56</sup>(...continued)

analysis performed here, the before-tax depreciation deductions are discounted to produce  $z$  which is then multiplied by  $r$ . Thus the appropriate discount rate is the before-tax debt rate the company could earn on the purchase of an investment grade corporate bond. If the tax shields were first calculated (deductions times the tax rate), then the appropriate discount rate for the tax shield cash flows would be an after-tax debt rate.

<sup>56</sup>Merrill Lynch, *Security Risk Evaluation*, March 1991.

<sup>57</sup>Moody's Investors Service, Inc., *Moody's Public Utility Manual*, 1990, and *Moody's Bond Survey*, February 25, 1991.



for IPPs placing their debt rates at 10.5 percent.<sup>2</sup> This should account for both any risk premium and differences in maturities between IOUs and IPPs.

#### Capital Structure

IOU investment is assumed to be funded with 50 percent debt and 50 percent equity, based on current observations. IPP investment is assumed to be financed with 90 percent debt and 10 percent equity.

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<sup>2</sup>Conversations with rating agency executives and investment banking houses confirms that the IPP-IOU debt rate differential is between 50 and 100 basis points, currently. These differentials will decrease in a post Title XV world where large companies become the major IPP developers. Consider Duke/Fluor Daniel as a potential IPP developer. In this partnership Duke Power Company has a Aa2 bond rating and Fluor Corporation has an A3 rating, better than most IOUs. If this partnership were to develop IPP projects with guaranteed minimum capacity payments, the debt interest rates would be virtually identical to an IOU's rates.

Table A1

# Present Value of Tax Depreciation Deductions

Annual Depreciation Deductions  
Per Dollar of Investment

Combined -- cycle Facilities	49.13
ADR Class	28
ADR Life	20
Tax Life	10.00%
Discount Rate	
Present Value	
Of Deductions	\$0.4424

Year	Steam Plants
1	\$0.0375
2	\$0.0722
3	\$0.0688
4	\$0.0618
5	\$0.0572
6	\$0.0529
7	\$0.0489
8	\$0.0452
9	\$0.0446
10	\$0.0446
11	\$0.0446
12	\$0.0446
13	\$0.0446
14	\$0.0446
15	\$0.0446
16	\$0.0446
17	\$0.0446
18	\$0.0446
19	\$0.0446
20	\$0.0446
21	\$0.0223

**STATEMENT OF MARK C. SHOLANDER  
GENERAL COUNSEL  
KANSAS CITY POWER & LIGHT COMPANY  
BEFORE THE  
SUBCOMMITTEE ON SECURITIES  
OF THE  
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS  
UNITED STATES SENATE  
SEPTEMBER 17, 1991**

Mr. Chairman and members of the Subcommittee, I am Mark C. Sholander, General Counsel of Kansas City Power & Light Company. Kansas City Power & Light Company is a medium-size electric utility and the corporate successor to one of the world's first electric companies, generating electricity since 1882. Headquartered in downtown Kansas City, Missouri, the Company generates and distributes electricity to over 410,000 customers in a 4,700 square mile area located in 23 counties in western Missouri and eastern Kansas. Customers include 360,000 residences, 47,600 commercial firms, and over 2,400 industrial firms, municipalities and other electric utilities. About two-thirds of the Company's total kwh sales are to Missouri customers and the remainder to customers in Kansas.

I appreciate the opportunity to present my comments urging this Subcommittee to recommend that the Banking Committee formally assert its jurisdiction over Title XV of S. 1220, as reported by the Senate's Committee on Energy and Natural Resources. Title XV

would provide a blanket exemption from the provisions of the Public Utility Holding Company Act of 1935 ("PUHCA") for holding companies owning 10 per cent or more of the voting securities of wholesale electric power generation companies, defined as "exempt wholesale generators" ("EWG's"). The practical effect of the exemption will be to allow independent holding companies to set up EWG's in a potentially unlimited number of states, or utilities to establish utility affiliates operating as EWG's outside of their service areas, without complying with the investor and consumer protection provisions of PUHCA. For the reasons I will indicate in my statement, I believe it is imperative that the Banking Committee assert jurisdiction over Title XV to ensure adequate review of the potentially serious and far-reaching effects of that legislation on the financial health of the electric utility industry and ultimately on the price and reliability of electric service.

Before I address the main arguments which have been presented in support of Title XV, it would be helpful to review some of the holding company abuses which led to passage of the PUHCA in 1935, which at least some supporters of Title XV feel need not concern us now:

- \* Before the PUHCA was passed, the holding company structure was a device by which state utility regulation was obstructed. Control was shifted from the local utility to the holding company owning its stock. That

holding company was often organized under the laws of another state.

\* Holding companies did not confine the establishment of their utility subsidiaries to any one region, but instead had ownership of operating properties throughout the U.S. This diluted management focus on the service needs of the customers located in particular service areas, and created the potential for hiding profits from regulators in the form of excessive intrasystem charges for management and engineering services.

\* Holding companies were highly leveraged, meaning that the bulk of the capitalization of the operating subsidiaries was in the form of debt. As a result, effective control of those subsidiaries could be maintained with a minimal equity investment by the holding company and its owners. This leverage (over-reliance on debt financing) created intolerable financial risk for the electric utility industry.

Currently there is a debate over whether these or similar abuses would be repeated if the PUHCA is amended as proposed to create an "exempt" class of wholesale utilities. Indeed, certain amendments have been included in Title XV in an effort to prevent at least some of those abuses from happening should Title XV be

enacted into law. (Notably, no amendment has yet been included to address the last of the problems identified above.) Unfortunately, these efforts to amend Title XV to protect consumers from a repeat of historical holding company abuses are somewhat misdirected because they ignore certain fundamental questions: why is the legislation needed in the first place and what would it do to the structure of the electric utility industry, and its efficiency and reliability, if it were enacted into law? Even if the legislation could be "fixed" to avoid all of the historical holding company abuses, Title XV presents extremely important policy issues which are often ignored in the debate over that legislation.

This can be demonstrated by a review of the main arguments which have been made in support of Title XV. Supporters of Title XV generally present one or both of two primary arguments in support of that legislation. The first argument is that Title XV is needed to assure adequate supplies of electricity for the nation, or that at the very least it will create new power supply "options" for the nation's electric utilities. The argument goes: instead of building new power plants for themselves, the utilities will, if they choose, be able to contract with EWGs to build and operate those power plants and will be able to purchase the electricity generated from those plants for resale to the consumers located in their service territories.

Little evidence is presented, however, to support this first argument. There is no electricity supply crisis in this country which mandates the passage of Title XV to foster the further development of the independent power industry. The North American Electric Reliability Council reported at page 4 of its 1990 Reliability Assessment: The Future of Bulk Electric System Reliability in North America 1990-1999 that, although confronted with certain risks identified in the study, "electric utilities have adequate plans for the 1990-1999 period to provide reliable electric service to their customers". Indeed many of the power supply plans reviewed by the NERC included purchases of power from independent non-utility generators. The evidence suggests strongly that Title XV is not required either for utilities to take advantage of the independent power "option" or for the nation to meet its future power supply needs.

As a result, it is the second main argument in support of Title XV which should be the focus of the real debate. This argument is that Title XV is necessary to unleash the forces of competition in the bulk power market for electricity (the market in which interconnected utilities buy and sell wholesale power from and to each other) by helping to foster a new class of independent power producers (the EWG's referenced in Title XV). The goal of those making this argument is to foster competition between EWG's and traditional, regulated local utilities for the right to build and operate generating plants, and thus for the right to generate

the electricity which is ultimately sold by the local utilities to their retail customers. In other words, instead of the traditional utility building and owning a new generating plant needed to provide service to its customers, an EWG would build the plant and sell the electricity at wholesale to the utility, which would resell it to consumers in its service area. To the extent this occurred, contracts for wholesale power with these "exempt" generating companies would replace direct ownership of new generating capacity by local utilities.

This claim that Title XV is the necessary first step towards fostering competition for the right to build and control new generating capacity of course implies that other steps will be necessary to accomplish that goal. Not surprisingly those who advocate increased competition in the bulk power market often advocate the following additional steps:

1. Mandatory competitive bidding for the right to build and own new generating capacity, to be administered by the respective state regulatory commissions.
2. Mandatory transmission access, to be administered by the Federal Energy Regulatory Commission.



3. Relaxation of wholesale price regulation by the Federal Energy Regulatory Commission for sales of power and energy taking place in the newly created competitive market for new bulk power supplies.

Combined with the passage of Title XV, these proposals would result in the effective deregulation of the market for new bulk power supplies of electricity. As a result, it is simply impossible to consider the impact which Title XV would have on the financial stability of the nation's electric utility industry without recognizing that that legislation is not being proposed in a vacuum, but is being proposed simultaneously with other important policy initiatives, the combined effect of which would be a far-reaching restructuring of the electric utility industry. And it is this proposed restructuring which gives rise to the key issue regarding Title XV: would deregulation of the bulk power market for electricity, and the fostering of competition between EWG's and local regulated electric companies for the right to own and control new generating capacity, benefit the ultimate consumers of electricity, without harming the long-run financial strength or reliability of the electric utility industry? The supporters of Title XV assure us that benefits would flow from that competition, and that this would occur without jeopardizing the financial health or reliability of the electric utility industry. Unfortunately, they base their assurances on certain unsupported assumptions.

These assumptions are that competition will assure that new electric generation facilities will be provided by the most efficient suppliers, and, that the resulting cost of generation, and the ultimate price for electric service, will be lower. However, it is not safe to make these assumptions. Indeed, the effort to create a deregulated, fully competitive bulk power market, with passage of Title XV as the first step towards that goal, could very well result in more costly, less reliable electric service provided by a financially weakened electric utility industry.

To understand how a deregulated, competitive market for new bulk power supplies could have this effect in the electric utility industry, it is first necessary to understand the current industry structure. Control area electric utilities today reflect a vertical integration of the generation, transmission and distribution functions, because they build and own the majority of the facilities necessary to simultaneously generate electricity, transmit it to load centers, and distribute to retail customers. These vertically integrated utilities are in turn interconnected with each other by high voltage transmission facilities which were constructed so that the utilities could provide each other with reliability back-up, allowing them to rely on each other in times of emergency. This permits them to reduce the amount of generation reserves which each would otherwise have to construct if they operated on a stand-alone, isolated basis. The existence of these

transmission interconnections also enables the utilities to engage in bulk power transactions with each other to save on generation costs, often referred to as "economy" or "opportunity" transactions. (For example, purchases are made from neighboring utilities, in lieu of self-generating, when those purchases are less expensive than self-generation, such as where coal-fired generation is available to replace more expensive oil-fired generation.) In other words, currently, there is coordination among utilities through power pooling rather than full-blown competition.

This interutility coordination has not been an accident. In fact, it is the direct result of the public policy which has been established for the electric utility industry by Congress. Section 202(a) of the Federal Power Act, which fortunately has not yet been superseded by a different expression of public policy, imposes a duty on the Federal Energy Regulatory Commission to "promote and encourage" voluntary interconnection and coordination among utilities.

This public policy favoring interutility coordination (not competition) has been extremely successful. For the nation as a whole, savings from all power pooling and other coordination activities were estimated to be \$15 billion in 1986, in a study in which my Company participated. (Caesasa, Lucas and Branca, Generation Planning and Transmission Systems, No. 37-02,

International Conference on Large High Voltage Electric Systems  
(1988), p. 1.)

Unfortunately, any effort to restructure the electric utility industry, to vertically disintegrate it to foster the development of a separate, fully competitive market for new bulk power generation resources, would jeopardize many of the efficiencies captured from the vertical integration and interutility coordination exhibited in the current industry structure. Let me first discuss the impact on coordination.

Essential to the successful operation of the interconnected power systems of this country is the open exchange of information among utilities. Such exchanged information includes projected loads and specifics about the design and operation of proposed new generation and transmission facilities. Studies of load flow, stability, and production costs are conducted requiring shared information concerning: (1) generator heat rates, outage rates and maintenance schedules, (2) transmission line ratings, (3) projected O&M costs, including fuel costs, (4) planned generation and transmission additions and retirements, (5) peak load forecasts, and (6) projected finance costs. Without the free flow of this kind of information, it would be impossible to develop the kinds of regional plans currently developed within power pools. Much of that exchange of information, however, would be discouraged if utilities were pitted against each other (through their EWG

subsidiaries) in a fully competitive bulk power market. Any utility will be reluctant to exchange information with an entity, be it an EWG or another utility, that would use that information for competitive purposes. You cannot compete and coordinate at the same time, and it would be unrealistic to expect utilities to try to do so with any degree of enthusiasm.

This is not a frivolous concern. Indeed, the North American Electric Reliability Council in its 1987 Reliability Assessment expressed the same concern (p. 41):

One adverse result of deregulation is likely to be reduced cooperation and communication among utilities as a result of being forced into competitive situations. The reliable operation of the interconnected generation and transmission systems has been possible only with the close cooperation and exchange of information among the system planners and operators of the various utilities. Any reduced coordination of planning and operation as a result of deregulation would adversely affect reliability.

Any such reduction in coordination activity would not only affect reliability, but would have direct cost impacts as well. A reduction in coordination would ultimately require individual utilities to increase their own generation reserve requirements.

Competitive considerations would not pose the only threat to continued coordination activities, and the savings they produce, if the industry is restructured to create a separate, fully competitive bulk power market. The mere proliferation of EWG's which would follow enactment of Title XV, and the implementation of the other policy initiatives I listed earlier, would increase

greatly the complexity of coordination activities. As John A. Casazza put it recently ("Free Market Electricity: Potential Impacts on Utility Pooling and Coordination", Public Utilities Fortnightly, February 18, 1988):

Among the disadvantages is that an increase in the number of participants makes the decision-making process much more difficult. Past pool experience has clearly shown that the ability to arrive at decisions rapidly decreases with increases in the number of participants.

The most serious difficulty, however, will be the participation in pool activities of organizations which do not have the responsibility to supply customers, who do not operate a transmission and distribution system, and whose only concern is the economic impact on their generation plant. The maintenance of overall system economy and system reliability under such situations will become very difficult. The minimization of total system cost will cease to be the objective of some members of the group. [Emphasis added.]

If the response to this increased complexity and conflict of interests is withdrawal from coordination activities by electric utilities, the result, again, would be a reduction in the reliability benefits provided by such activities and an increase in the generation investment (reserves) and fuel costs which would have to be incurred by individual utilities.

The potential loss of interutility coordination, and the reliability and cost savings such coordination has produced, would not be the only risk posed by any effort to deregulate the bulk power market to foster competition. As I suggested earlier, benefits currently obtained by vertical integration would also be jeopardized. When the generation, transmission and distribution of electricity are all provided within the same company, power supply

is primarily not obtained externally by contract, but is provided internally within the company, and the costs of contracting for that power and of monitoring and enforcement of those contracts are avoided. (Obviously, a company doesn't have to sue itself to assure performance.) With deregulation of the bulk power market, a greater and greater percentage of power supply would be obtained by contract with EWG's as the industry became vertically disintegrated.

For power supply contracts with EWG's, both the potential for opportunism by the EWG and the resulting cost of contract enforcement would be quite high. I say this not because of any belief that EWG's will be unusually untrustworthy or opportunistic. The potential for opportunism (and contract enforcement cost) will stem from the potentially adversarial economic relationship with the EWG, as suggested by Casazza in the previous quote, and the inherent difficulty of anticipating, and resolving, disputes in a contract governing the operation of an asset like an electric generating unit, given the complexity of the transaction and the magnitude of the investment in the unit and its lengthy operating life. Accordingly, it is inevitable that there would be costly contract disputes at some point during the contract term. With no legal duty to serve, any financially troubled EWG would be tempted to walk away from an unprofitable service provided under a contract with a purchasing utility, or to seek renegotiation to get a price not originally bargained for. For example, if the contract becomes

sufficiently uneconomic to the EWG, there is no question but that the EWG would attempt to invoke the force majeure clause inevitably to be contained within the contract or would invoke the doctrine of commercial frustration of purpose (Section 265, Restatement of Contracts 2d) in an effort to obtain a renegotiation of the deal.

Regardless of the validity of its legal arguments, however, the EWG would have considerable leverage to obtain its price demands, given the "lock-in" effect described by Joskow and Schmalensee in their book Markets for Power: An Analysis of Electric Utility Deregulation (1983) at pp. 111-112:

When durable transaction-specific assets are involved in a transaction [such as a generating plant], there is a natural asymmetry between the position of the bidder before a contract is signed (ex ante) and after the assets are in place (ex post). In the bidding stage there may be many bidders vying to supply. After the contract is signed and assets are in place, however, the many-bidders situation is transformed into a situation of bilateral exchange. More simply described as a lock-in effect, this generally affects the behavior of both parties to a contract. Most important it provides an important condition for costly opportunistic behavior by one or both parties to a contract.

In other words, because the power supply contract with an EWG would involve such a significant "transaction-specific asset" -- the new generating plant -- the purchasing utility will be "locked-in" to the contract once the plant is built because it will absolutely require the generating capacity provided by that plant. After all, the plant is being built as a substitute for the utility building the same plant to help meet the demand for electricity by its customers which the utility is obligated to meet



instantaneously as it occurs. In that situation, the supposedly competitive nature of a deregulated bulk power market would not serve as a realistic check on opportunistic behavior by the EWG because of the impossibility of constructing substitute generating capacity on short notice. Of course, EWG's would not be equally vulnerable to opportunistic behavior by the purchasing utility from the "lock-in" effect described by Joskow and Schmalensee, particularly if an unconditional mandatory transmission access obligation were imposed on electric utilities, which many proponents of deregulation are advocating specifically to provide EWG's access to utilities other than the initial purchasing utility. (Somehow, only the purchaser needs to be disciplined, not the seller.) Paradoxically, such mandatory transmission access would only serve to enhance the leverage which the EWG has over the purchasing utility, increasing its ability to engage in opportunistic behavior.

It is this "lock-in" effect, and the potential for opportunism to which it gives rise, which helps distinguish the electric utility industry from other industries which have recently undergone some form of deregulation in an effort to harness "market forces" to regulate supply and price. The size of the investment required to construct new generating capacity, and the significant lead times required for the construction itself, will preclude the development of some sort of a disciplining "spot market" for generating capacity to which a purchasing utility could immediately

resort in order to avoid making concessions to an EWG exhibiting opportunistic behavior. Surplus generating capacity simply will not be constructed on speculation for such a spot market. This means that the threat of non-performance by a wholesale supplier is much more serious to an electric utility than in other industries, given the utility's obligation to generate electricity to serve electric load instantaneously as it occurs. For this reason, any utility purchasing a significant amount of generating capacity from EWG's will have to provide greater generating reserves than if it had built and owned the generating capacity for itself. In its March 26, 1990 CreditComment entitled "Utilities' Risks in Purchasing Power", Standard & Poor's estimated that increasing reliance on EWG's may require generating reserve margins 3% to 5% higher than the current industry average reserve margins of 15% to 17% to compensate for this higher reliability risk.

Up to this point, I have described two sources of additional cost which would result from the vertical disintegration which would accompany industry restructuring -- the significant contract enforcement costs which utilities would be forced to incur and the costs of the additional generating reserves which they would have to provide if they relied on a significant amount of EWG generating capacity. I have alluded to another cost which could be even more significant -- the increased prices which the purchasing utility would be required to pay over the term of the relevant contract if it is forced to accede to demands for price concessions by a

financially troubled EWG. Such an increase in price would occur, in any event, upon the termination or expiration of the contract with the EWG. (When the contract is terminated or expires, the purchasing utility would have to find replacement power or extend the contract with the EWG. Presumably, that could be obtained only at the then prevailing market price.) Any increase in price, however, whether from a forced renegotiation of the contract during the contract term, or from the acquisition of replacement power upon its termination, represents an obvious loss of whatever bargain the purchasing utility thought it was getting when it initially contracted with the EWG as a substitute for building the generating plant for itself. And, it is precisely this potential for such a loss of bargain which makes it impossible to conclude that any contract with an EWG represents a "least-cost" alternative to the utility building the generating capacity for itself.

Unfortunately, the threat to reliability, and cost of increased generation reserves, resulting from lessened interutility coordination, and the contract enforcement costs (and risk of contract renegotiation) resulting from vertical disintegration of the industry, are not the only costs likely to be imposed on the nation's utilities in the aftermath of industry restructuring. The utility purchasing a significant portion of its generation requirements from EWG's is going to wind up with a higher cost of capital. Any apparent price advantage offered by an EWG would primarily be the result of how the EWG generation project would be

financed. Independent power projects are generally highly leveraged, being financed with up to 90% debt. This leveraging would give the EWG an apparent cost advantage over a traditional regulated utility, whose capitalization must contain a significantly smaller percentage of debt, and a higher percentage of more costly equity.

However, such highly leveraged financing would be available to the EWG only if the utility offered to incur some "take-or-pay" obligation in its contract with the IPP, or offered similar terms to provide the EWG with an assured market at a known price. This would effectively assign much of the market risk of the EWG project to the utility, which would correspondingly increase its cost of capital. (Market risk is the risk that the generating capacity will not be needed, or that it will prove uneconomic, and thus will be underutilized.) In other words, the EWG contract would be treated as the equivalent of debt to the utility, meaning that its equity capital would be required to back up the highly leveraged financing of the EWG project.

Importantly, it is not sufficient to respond to this concern with the argument that the utility would have had to absorb the same market risks if it had built the power plant for itself. This argument overlooks the fact that when the utility builds the plant for itself it is allowed a return on its investment which presumably compensates it for assuming these risks. However, when

a contract with an EWG is substituted for direct utility ownership, no such return is earned, unless state regulators allow specific compensating adjustments to the return allowed on the utility's remaining investments. Given the current regulatory climate, the prospects for such specific, compensating adjustments to allowed returns are slim at best.

It is likely that the nation's electric utilities would be required to absorb even other costs if the industry is restructured in an effort to create a separate, fully competitive market for bulk power supplies in which EWG's would participate. As I mentioned earlier, one aspect of the deregulation scenario now advocated by many proponents of industry restructuring is mandatory transmission access. Although transmission access requirements are not (yet?) part of Title XV of S. 1220, there is legislation which is currently being considered in Congress which includes transmission access requirements, along with the amendments to PUHCA contained in Title XV. (See, for example, H.R. 2825 submitted by Representative Tauzin.) I have alluded to one of the rationales for these transmission access requirements--the perceived need to create "secondary markets" to which EWGs could resort upon the termination or expiration of their contracts with their initial purchasers. If the current versions of the transmission access legislation now being proposed in Congress were to be enacted into law (along with the provisions of Title XV), the nation's electric utilities will probably be required to absorb

certain real costs associated with providing transmission services to EWG's. Let me explain.

Currently, utilities minimize the costs of both their generation and transmission by planning both jointly. The siting of generating plants in relation to primary expected load centers is coordinated with the planning of the transmission system. Obviously, this could still be accomplished in a competitive bidding program by specifying to the bidding EWG's where the plant is to be built. However, any requirement to provide transmission services to EWG's, to allow them to shop their generating capacity around in secondary markets, could require the purchasing utility to expand the capacity of its transmission system specifically to provide those transmission services. Many utilities may not be able to do this, however, given constraints on the construction of new transmission capacity due to increasing urbanization and heightened local environmental concerns. The Federal Energy Regulatory Commission has made it clear in recent cases where it has imposed transmission access conditions that, where such constraints on transmission system expansion do occur, the utility should be required to forego making economy transactions with other utilities, which directly benefit its own service area customers, in order to provide the transmission capacity needed to support the long-term transactions of third parties (including independent power producers).

I noted earlier that the ability to make these economy transactions is one of the benefits which utilities currently obtain from interutility coordination. As a result, any requirement that these economy transactions be foregone to provide firm transmission service to third parties would represent a very real cost associated with providing those services. (Economists refer to such foregone alternative benefits as "opportunity costs".) Yet, there is very real doubt that the FERC is inclined to allow the utility to charge the entity requesting the firm transmission service for the loss of those benefits for its native load customers. Clearly, to the extent utilities are not allowed to recover such opportunity costs from the entity requesting the transmission service, the true effect on efficiency of the supposedly competitive bulk power market will be masked. And, the financial health of the nation's electric utilities will be further jeopardized as they are required to absorb yet another cost resulting from deregulation, with consumers ultimately being required to pay the price.

Unfortunately, the transmission access legislation which is currently pending in Congress would not require the FERC to allow opportunity costs to be included in the prices charged for transmission services. Even more serious is the fact that that legislation would actually permit the FERC to order transmission access in order to foster the development of a fully competitive bulk power market, even if it jeopardized the reliability of the

retail service provided by the utility owning the affected transmission facilities, as long as the FERC concluded that the loss of reliability was not "undue". This is a perfect example of the very real sacrifices which could be made in the blind pursuit of deregulation in the electric utility industry.

There are certain conclusions which are inescapable from the preceding review of the kinds of inefficiencies and costs which could result from the current efforts to create a separate, deregulated competitive market for new bulk power supplies of electricity. First of all, it is simply inappropriate and irresponsible to assume away all of these potential costs and inefficiencies when debating the potential for enhancing the efficiency of the bulk power market for electricity by deregulating it. It is an empirical question whether electricity is still most efficiently provided by the prototypical vertically integrated, regulated utility which participates in interconnected power pools, or whether full competition in a separate, deregulated bulk power market offers any net efficiency gain, without jeopardizing reliability. This is not a debate between two competing religious faiths, although it often sounds like one.

Second, we do not yet have sufficient information to definitively answer the empirical question I just posed, although it should be clear from my comments that I suspect the nation will be worse off from the deregulation scenario currently being



proposed. As a result, it is entirely premature to start implementing the deregulation scenario by enacting into law its various aspects piecemeal, such as Title XV and mandatory transmission access. Looking before you leap is still good advice, particularly when you have plenty of time to do the looking. As I mentioned earlier, there is no immediate national electricity supply crisis justifying haste.

Third, if the nation does rush to judgment on these issues, before adequate analysis has been brought to bear, and if the risks I have identified in my comments materialize, the consequence to the nation will be profound and far-reaching. Not only will the financial health of the electric utility industry be unnecessarily jeopardized, but the reliability of electric service, so essential to consumer well-being, will be degraded at the same time its cost will rise.

For all of these reasons, I urge this Subcommittee to recommend that the Banking Committee formally assert its jurisdiction over Title XV of S. 1220 and to initiate the review these issues demand.

**UNITED STATES SENATE  
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS  
SUBCOMMITTEE ON SECURITIES**

**STATEMENT OF THE  
NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS  
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**FOR THE HEARING RECORD ON  
LEGISLATION TO AMEND THE  
PUBLIC UTILITY HOLDING COMPANY ACT OF 1935  
(PROVISIONS OF TITLE XV OF S. 1220)**



**SEPTEMBER 18, 1991**

Chairman Dodd and Members of the Subcommittee:

The National Association of Regulatory Utility Commissioners (NARUC) appreciates this opportunity to submit written testimony on amendments to the Public Utility Holding Company Act contained in Title XV of S. 1220, "The National Energy Security Act of 1991."

As the representative of the State regulatory commissions responsible for regulating the retail rates and services of these electric companies, the NARUC is concerned that the passage of Title XV not frustrate the ability of these commissions to ensure that utility purchases of wholesale power are in the public interest. Our basic position with respect to this legislation is based on the attached resolution that was adopted by the NARUC in 1989 (see Attachment #1)

In reporting S. 1220 to the Senate floor, the Committee on Energy and Natural Resources recognized the need to protect State regulation by including in Title XV Section 15106, entitled "State Authority." This provision would amend Section 209 of the Federal Power Act (FPA) to provide that as a general matter, wholesale rate orders of the Federal Energy Regulatory Commission (FERC) would not preempt State authority to determine the prudence of the purchase of wholesale power from the perspective of the retail utility making the purchase.

The NARUC strongly supports this aspect of Section 15106. However, in addition to protecting State prudence authority, the section includes two additional provisions which should be deleted or revised. First, Section 15106 amends Section 209 of the FPA to include a "provided" clause which would give a utility the right to require State commissions to "preapprove" the prudence of the utility's decision to accept an offer from an exempt wholesale generator (EWG) to sell power; second, the section would preempt State prudence regulation of wholesale power sales and allocations which occur within a registered holding company system, except for wholesale purchases from EWGs, which would not be preempted.

We object to the "preapproval" provision for at least three reasons:

- o First, some States now preapprove the prudence of a variety of utility actions, including wholesale power purchases, under the provisions of State law and regulations. However, requiring Nationwide preapproval through Federal legislation would constitute an unprecedented intrusion into State ratemaking authority. Despite its increasing interest in utility issues (as exemplified by the 1978 enactment of the Public Utility Regulatory Policies Act (PURPA)), Congress has never dictated to the State commissions how they should decide

one of the central issues of utility regulation -- the timing and methodology for recovering utility costs of service.

o Second, this provision leaves the preapproval decision up to the utilities, and not the State commissions. As a result, by this legislation, Congress has delegated to utilities the right to dictate a State commission's agenda. This too is unprecedented.

o Third, by limiting the preapproval requirement to purchases from EWGs, and no other wholesale suppliers, this provision discriminates against a source of supply which ironically enough, Title XV seeks to promote. In our view, Congressional creation of new categories of power suppliers, subject to new and different regulatory rules, runs directly counter to the philosophy of the bill as well as current regulatory trends which seek to evaluate all supply and demand options on an even-handed basis.

In short, the NARUC strongly opposes this effort to prescribe State regulatory policies and procedures, and urges that the language be removed.

The provision of Section 15106 which preempts State prudence reviews within the context of registered holding company systems has similar defects:

o First, this provision also discriminates against purchases from EWGs.

o Second, by preempting State jurisdiction over the retail rates of the retail utility subsidiaries of registered holding companies, this provision both displaces State regulatory authority and places the interests of millions of retail ratepayers at risk of higher utility rates.

o Third, the NARUC strongly believes that multistate transactions of registered systems are most appropriately regulated at the regional level. However, since the Energy Committee failed to include provisions in its bill to authorize the establishment of regional regulatory approaches, and instead preempted the States, the NARUC must strongly oppose this aspect of Section 15106.

In addition to opposing the preemptive aspects of Section 15106 of S. 1220, we believe a more comprehensive treatment of registered holding company systems is needed. The NARUC has called for amendments to the FPA authorizing the creation of regional regulatory approaches to holding company issues in a resolution adopted by the Association's Executive Committee earlier this year (see attachment #2). A legislative proposal to address this question has been jointly drafted by the Arkansas Public Service

Commission and Entergy, a registered holding company, and will possibly be offered as a floor amendment to Title XV. The NARUC supports this approach in concept, but has not yet developed an official position on the specific elements of the Arkansas/Entergy proposal. We urge the members of this Subcommittee to support a regional approach to the very real regional regulatory issues that PURCA reform raises.

There are other provisions of Title XV that we believe your Subcommittee should consider before this legislation is taken up on the Senate floor. These are found in Sections 15103, 15107 and 15108 of the legislation.

o Section 15103. This section, entitled "Prevention of Stranded Investment," prohibits the FERC from approving a wholesale sale from an EWG if it anticipates that the State commission regulating the utility purchasing the power will remove from retail rate base generating plant owned by the utility. In other words, this section would prohibit FERC from approving EWG sales which it believes a State commission will use to offset generation from existing capacity. The NARUC opposes this provision as both unnecessary (i.e. there is no evidence that State commissions would "strand" investment in existing capacity) and unworkable (i.e. how will FERC determine what a State commission will do in the future, short of mind reading?).

o Section 15107. This section amends Section 111 of PURPA to require each State commission to conduct hearings and make written determinations on whether or not to adopt regulatory standards on (1) the effect on retail rates of utility decisions to rely on wholesale power purchases rather than construction; (2) the effect on reliability of wholesale power purchases from sellers with debt levels higher than the purchasing utility; (3) whether EWGs with less than 35% equity will harm reliability and competition; (4) procedures for advance approval of wholesale power purchases which reflect the results of 1-3; and (5) whether wholesale sellers of power have reliable sources of fuel. Because this section amends Section 111 of PURPA, State commissions are not required to reach any specific substantive result in these evaluations. This section is a compromise from earlier amendments which would have established mandatory limitations on financing, fuel supply reliability, and debt/equity ratios. The NARUC opposed both the earlier amendments and the compromise that was adopted on the grounds that such provisions are unnecessary (because State commissions take these matters into consideration anyway) and administratively burdensome (because substantial State commission resources would be required to hold a series of hearings, issue decisions etc.).

o Section 15108. This section provides "affected" State

commissions with a right of access to the books and records of EWGs. An "affected" commission regulates (1) the rates of the purchasing utility; or (2) a utility affiliated with the EWG, including affiliation via a holding company. The NARUC supports this provision but urges that the section be amended to provide access to out-of-State books and records of non-EWG utility affiliates as well.

Finally, we wish to comment on the linkage of transmission access with PUHCA reform legislation. The NARUC has not taken a position on the linkage of these two major legislative initiatives; however, we believe that if the Congress does decide to incorporate language concerning wholesale transmission issues in its PUHCA reform package, there should be a recognition of the need for reforming the way in which the Nation's current transmission infrastructure is regulated today. We believe that this reform is needed to avoid unnecessary delay in building new transmission capacity and in achieving the maximum efficiency from the system that is now in place. At its Summer Committee Meeting this July, the NARUC Executive Committee adopted a resolution outlining what we believe to be the major policy questions that need to be addressed in transmission legislation (see attachment #3).

In conclusion, the NARUC believes that legislation amending the 1935 holding company act affords Congress the opportunity to decide some fundamental questions concerning the balance between Federal and State jurisdiction over traditional electric utilities and the new entrants to the power industry that this legislation would allow. The answers to these questions will largely determine the ability of this legislation to meet its stated goal of increasing competition and economic efficiency in the electric power industry so that consumers will ultimately benefit.

## ATTACHMENT #1

**Resolution on Reform of  
the Public Utility Holding Company Act**

**WHEREAS**, Legislation is pending before the Senate Committee on Energy and Natural Resources, S. 406, to amend the Public Utility Holding Company Act of 1935 (PUHCA); and

**WHEREAS**, The legislation would create a new category of electric generator called Exempt Wholesale Generators (EWGs) which would not be subject to the regulatory restrictions imposed on holding companies by PUHCA; and

**WHEREAS**, The purpose of this bill is to greatly reduce the barriers to entry for holding companies, including electric utilities, to enter wholesale markets and sell power to distribution utilities for resale to consumers; and

**WHEREAS**, The addition of new EWGs to wholesale markets subject to regulation by the Federal Energy Regulatory Commission (FERC) will erode State control of an increasingly large percentage of the cost of electrical service, particularly if the FERC and the Federal Courts continue to hold, in reliance on Mississippi Power & Light v. Mississippi ex rel. Moore, 487 U.S. \_\_ (1988), that State commissions have severely limited jurisdiction to review the passthrough of purchased power costs in retail rates; and

**WHEREAS**, By permitting unrestricted utility ownership of EWGs, the legislation creates the opportunity for utilities to cross-subsidize their construction and operation of wholesale power facilities through their retail distribution rates, particularly utilities owning and operating EWGs which sell power to affiliated distribution companies; and

**WHEREAS**, The substance of this Resolution is reflected by the Resolution of the same Title adopted by the NARUC Executive Committee on July 27, 1989; now, therefore, be it

**RESOLVED**, That the National Association of Regulatory Utility Commissioners (NARUC), convened in its 101st Annual Convention in Boston, Massachusetts, strongly opposes amendment to the Public Utility Holding Company Act of 1935 unless provisions are included which specifically preserve the legal authority of the respective State commissions to insure that the sale of power by new entrants into wholesale markets is in the interest of retail ratepayers. Such provisions must:

- (1) Ensure the right of each State commission to review the prudence of the wholesale purchasing practices of each distribution utility subject to the State commission's authority; and
- (2) Preserve the right of each State commission to conduct bidding programs and least cost planning; to determine the appropriate mix of generation, as a matter of fuel and technology choice and as a matter of ownership; to take actions to insure system reliability; to restrict or prohibit affiliate transactions;

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- and to approve or disapprove the transfer of assets from a utility to another party, free from preemption under Federal statutes or the Commerce Clause; and
- (3) Provide a right of access, enabling State commissions to review the books and records of holding companies and all holding company subsidiaries, including non-regulated businesses that transact business with the retail distribution company or EWG entity; and
  - (4) In the case of an integrated multi-State utility holding company, authorize regional compacts for those States who have jurisdiction over retail subsidiaries of the holding company for the sole purpose of regulating the allocation of costs and/or the prudence of wholesale power purchases by the holding company.

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Sponsored by the Committees on Electricity, Energy Conservation,  
and Finance and Technology  
Adopted November 15, 1989



## ATTACHMENT #2

**Resolution Endorsing Legislation to Amend the  
Federal Power Act to Reform State/Federal Jurisdiction**

**WHEREAS**, In enacting the Federal Power Act in 1935, Congress granted the Federal Power Commission, predecessor to the Federal Energy Regulatory Commission (FERC), jurisdiction to regulate the wholesale sale and transmission of electricity in interstate commerce while preserving State jurisdiction over local rates and services of utilities; and

**WHEREAS**, In 1964, the U.S. Supreme Court held in Federal Power Commission v. Southern California Edison Co., 376 U.S. 205 (1964) (the Colton case) that Federal jurisdiction over wholesale sales included entirely intrastate wholesale transactions, thereby extinguishing State intrastate wholesale authority; and

**WHEREAS**, In a series of decisions culminating in its decision in Mississippi Power & Light v. Mississippi ex rel. Moore, 487 U.S. 354 (1988), the Supreme Court has sharply restricted the authority of the States to regulate the passthrough in retail rates of a utility's FERC-regulated costs of power purchased at wholesale; and

**WHEREAS**, Despite these decisions, the bulk of electric power costs and rates are determined by State regulatory commissions, including the costs of facilities used to provide wholesale sales and transmission service for which FERC establishes rates and conditions of service. Moreover, States retain exclusive jurisdiction over the siting of transmission facilities used for both inter and intrastate service; and

**WHEREAS**, In recent years, the electric utility industry has undergone substantial change as a result of increased reliance on wholesale power suppliers, including non-utility generators, greater regional coordination of power supply planning and operations, mergers and consolidations of utility operations in multiple jurisdictions, and increased transmission access by third parties. As a result, the FPA's jurisdictional allocation of authority is no longer consistent with the manner in which the industry now operates; now, therefore, be it

**RESOLVED**, That the Executive Committee of the National Association of Regulatory Utility Commissioners (NARUC), convened at its Winter Meeting in Washington, D.C., hereby calls upon Congress to amend the Federal Power Act in order to reform State and Federal jurisdiction over electric utility transactions to conform to the operational reality of the industry; and be it further

**RESOLVED**, That such amendments to the Federal Power Act be based upon the following principles:

1. Jurisdiction over the retail rates and services of electric utilities shall remain with the States. Such jurisdiction must be strengthened to affirm the authority of the States to regulate the passthrough of purchased power costs in the retail rates of utilities;

2. Jurisdiction over intrastate wholesale sales and transmission rates, terms and conditions should be returned to the State regulatory commissions;

3. Jurisdiction over multistate transactions (including system cost allocation, bulk power purchases and sales, emission allowance allocations, and use of transmission facilities) within registered holding company systems operating should be lodged in regional regulatory bodies authorized by Congress and established on a purely voluntary basis by the States in which the systems operate. In the event such regional bodies are not formed, or if formed, decline to regulate given issues, jurisdiction shall be lodged in the FERC except to the extent the electric utility subsidiaries of such holding companies are exempt from FERC jurisdiction over such issues pursuant to Section 201 of the Federal Power Act, 16 U.S.C. sec. 824, or successor provision(s). Jurisdiction over multistate transactions of other utility systems should also be exercised by such voluntarily-established regional bodies, but without default to FERC.

4. Congress should authorize the creation of multistate compacts consistent with basic principles of administrative efficiency and fairness. States which voluntarily form such compacts would collectively determine rules of governance and internal procedures; and be it further

**RESOLVED,** That the following principles govern the siting of transmission facilities to be used in multistate transactions:

1. States exercising jurisdiction over the siting and certification of transmission facilities should not discriminate against interstate facilities, meaning that interstate facilities should be sited, certificated, and otherwise regulated under the same standards and procedures as intrastate facilities.

2. States should retain jurisdiction to make all factual determinations concerning transmission siting. Judicial review of such determinations, whether in State or Federal courts, should not be de novo, assuming the States have conducted evidentiary proceedings.

3. Congress should authorize the creation of multistate compacts which permit willing States to:

a. Identify regional bulk power market needs for State siting agencies to consider in their respective deliberations; and

b. Plan for the construction of new interstate transmission facilities.

4. Congress should further authorize the creation of multistate compacts which permit willing States in which an interstate transmission facility is proposed to be sited:

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*a. To issue certificates authorizing the construction of the proposed facility;  
or*

*b. If States choose to retain certification authority for themselves, to agree  
upon and employ a mechanism for a final, binding resolution of a proposed  
facility siting when the individual States involved have come to conflicting  
and/or inconsistent determinations in their respective deliberations.*

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*Sponsored by the Committee on Electricity*

*Adopted February 27, 1991*

*Reported NARUC Bulletin No. 9-1991, pages 22-23*

## ATTACHMENT #3

**Resolution on Administrative and Legislative  
Reform of Electric Transmission Policy**

**WHEREAS**, Electric utility transmission, interconnection and wheeling policies are based upon an outdated Federal regulatory system which has resulted in an irrational jurisdictional allocation of authority under which the States exercise jurisdiction over the siting and cost recovery of transmission facilities, while the Federal Energy Regulatory Commission (FERC) claims exclusive jurisdiction over transmission pricing, and terms and conditions; and

**WHEREAS**, By the 1978 enactment of the Public Utility Regulatory Policies Act, the FERC's 1985 Notice of Inquiry (NOI) on transmission issues, and the report of the FERC Transmission Task Force, the Federal government has attempted to develop coherent transmission policies, thus far unsuccessfully; and

**WHEREAS**, The National Association of Regulatory Utility Commissioners (NARUC) supported Federal efforts to generically address transmission access and pricing policies, including the FERC's generic NOI, although we are troubled by the lack of a collaborative approach; and

**WHEREAS**, The FERC has announced its intention to conduct Federal/State Workshops in the Fall to consider, inter alia, ways in which FERC and State transmission policies and decisions can be better coordinated; and

**WHEREAS**, Legislation is now pending in the Congress which would amend the Federal Power Act to provide FERC greater authority to order interconnection and wheeling, over utility objections, under pricing and access terms which may affect the interests of the ratepayers; and

**WHEREAS**, This legislation, while useful in framing this necessary debate, may be premised on the false assumption that the FERC now has or should have exclusive jurisdiction over all issues of transmission access and pricing, including transactions which are intrastate in nature, without regard to the fact that under current regulatory procedures, the States are responsible for authorizing utilities to recover residual costs from native load ratepayers; and

**WHEREAS**, At its 1991 Winter Meeting, the NARUC Executive Committee adopted a resolution which, inter alia, called for congressional legislation (1) to provide State commissions with clear jurisdictional authority to regulate intrastate transmission transactions; (2) to authorize the voluntary formation of regional bodies to regulate regional transmission planning, siting, pricing, and access issues; and (3) to establish non-discriminatory standards for interstate siting issues; and

**WHEREAS**, There is a critical need for Federal/State

cooperation to examine, and develop coherent transmission policies; now be it therefore,

**RESOLVED**, That the Executive Committee of the National Association of Regulatory Utility Commissioners (NARUC), convened at its Summer Meeting in San Francisco, California, reaffirms its existing resolution on transmission issues described above, and hereby adopts the following principles with respect to administrative and legislative initiatives to reform electric utility transmission policies:

1. It is appropriate for Congress to begin addressing transmission issues.
2. Congress should require that the FERC and the State commissions conduct a joint, comprehensive examination of the current status of the transmission system on a regional and national basis through the use of a new FERC/State Joint Board mandated by Congress, including an analysis, and possible recommendations, on the respective jurisdictional responsibilities of the States and FERC, and principles of transmission pricing. The Joint Board would report to the Congress the results of its inquiry within 18 months of its establishment;
3. The relevant regulatory body needs authority to mandate access to transmission facilities as appropriate;
4. The following elements should be present in any Congressional legislation:
  - a. Intrastate transmission transactions should be regulated by the State commissions;
  - b. Regional transmission transactions should be regulated by voluntary regional bodies, as described in the earlier NARUC resolution;
  - c. Any authority to mandate transmission should prohibit federally mandated retail wheeling and include adequate protection for the interests of retail native load ratepayers;
  - d. Congress should provide FERC and/or interstate compacts with sufficient latitude to determine rates and access for interstate transmission services;
  - e. Any authority granted FERC to order the construction or expansion of transmission facilities should not preempt State or regional authority. Such jurisdiction should be concurrent.

5. If transmission legislation advances in the 102nd Congress, the NARUC intends to join those utilities, consumer groups, and independent power firms supporting transmission reform in shaping appropriate legislation which includes the above principles. NARUC is particularly appreciative of the willingness of the sponsors of H.R. 2224 to work with us as they consider this legislation;

6. The NARUC strongly suggests that the bills address and accommodate these principles. Since the currently pending transmission bills do not appropriately address the above matters, the NARUC cannot support them as now drafted.

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Sponsored by Committee on Electricity

Adopted July 24, 1991

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Pacific Gas and Electric Company

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September 17, 1991



The Honorable Christopher J. Dodd  
Chairman  
Subcommittee on Securities  
Committee on Banking, Housing,  
and Urban Affairs  
United States Senate  
541 Dirksen Office Building  
Washington, D. C. 20510

Dear Mr. Chairman:

Attached is a statement by Mason Willrich, President and Chief Executive Officer, PG&E Enterprises, submitted on behalf of Pacific Gas and Electric Company. Please include the statement in the record for the September 17, 1991, hearing of the Securities Subcommittee on legislation (Title XV of S. 1220) to alter the Public Utility Holding Company Act of 1935.

Sincerely,

  
Robert D. Testa

cc: Honorable J. Bennett Johnston  
Honorable Malcolm Wallop  
Honorable Alan Cranston  
Honorable John Seymour

**STATEMENT OF PACIFIC GAS AND ELECTRIC COMPANY (PG&E) ON  
TITLE XV OF THE NATIONAL ENERGY SECURITY ACT OF 1991  
TO AMEND THE PUBLIC UTILITY HOLDING COMPANY ACT**

**Submitted to the Committee on Banking, Housing and Urban Development  
Securities Subcommittee  
U.S. Senate**

**by**

**Mason Willich**

**President and Chief Executive Officer,  
PG&E Enterprises**

**September 17, 1991**



### EXECUTIVE SUMMARY

The Pacific Gas and Electric Company (PG&E) supports passage of Title XV of the National Energy Security Act of 1991 (S. 1220) and its provisions for Public Utility Holding Company Act (PUHCA) reform. PG&E supports PUHCA reform both as a buyer of power from independent producers and as an owner of a company which produces and sells power to other utilities.

The proposed amendments to PUHCA, which would create "exempt wholesale generators", have been a source of considerable controversy within the electric power industry. One issue in the debate concerns financial risk. Some opponents of PUHCA reform assert that the allocation of risk in power sales agreements between utilities and independent power producers is intrinsically anti-competitive and will fail to provide a least-cost electric power supply. This argument is advanced despite the fact that such agreements are being forged between buyers and sellers in a wholesale power market that is intensely competitive. This testimony addresses the issue of risk allocation between utility buyers and independent power sellers in the wholesale electric power market.

The conclusions which emerge from the discussion are: (1) that electric utilities and independent power producers are sophisticated buyers and sellers engaged in complex transactions; (2) that the power contracts they negotiate shift substantial risks related to power plant project development, construction, operation and finance from utility customers and shareholders to independent producers; (3) that risks remaining with utilities are generally appropriate, in particular the retail market risk of utility customer electricity demand; and (4) that, overall, contracts for the purchase and sale of electricity in a competitive wholesale power market result in an efficient and equitable allocation of risk between utility customers, utility shareholders, and independent power producers.

# PG&E SUPPORTS PASSAGE OF TITLE XV OF S. 1220

The Pacific Gas and Electric Company (PG&E) supports passage of Title XV of the National Energy Security Act of 1991 (S. 1220) and its provisions for Public Utility Holding Company Act (PUHCA) reform.

PG&E has the perspective both of a utility buyer of electric power and of an independent power producer. PG&E is the nation's largest investor-owned combination gas and electric utility, serving 11.8 million people in northern and central California. As a utility, PG&E buys approximately 4,200 megawatts of capacity from independent power producers operating Public Utility Regulatory Policy Act (PURPA) Qualifying Facilities ("QFs"). In 1990, PG&E purchased 14,070 million kilowatt hours of electricity from these facilities, sufficient to provide 19 percent of its electric energy requirements.

PG&E also has substantial experience as a non-utility, independent generator through its wholly-owned subsidiary, PG&E Enterprises. PG&E Enterprises is participating, through its Generating Company affiliate, in 13 projects which, when completed, will provide more than 2,000 megawatts of capacity to utilities outside PG&E's service area. The Generating Company's aim is to become one of the nation's leading independent suppliers of power to utilities purchasing from competitive wholesale electricity markets.

PG&E supports PUHCA reform, therefore, both as a buyer of power from independent producers and as an owner of a company which produces and sells power to other utilities.

The proposed amendments to PUHCA, which would create "exempt wholesale generators", have been a source of considerable controversy within the electric power industry. One issue in the debate concerns financial risk. Some opponents of PUHCA reform assert that the allocation of risk in power sales agreements between utilities and independent power producers is intrinsically anti-competitive and will fail to provide a least-cost electric power supply. This argument is advanced despite the fact that such agreements are being forged between buyers and sellers in a wholesale power market that is intensely competitive. If PUHCA is reformed, will risk be allocated efficiently and equitably between independent power producers and electric utility buyers? Will risk be allocated in a manner which helps ensure that American consumers -- large and small -- will have ample supplies of electric power for reasonable prices?

In considering how financial risk allocation and the proposed PUHCA reforms affect the reliability and cost of electric power supply, the Committee and the Congress should consider four principal issues:

First, can Exempt Wholesale Generators, as defined by the proposed legislation, play a useful role in meeting future needs for electric power in the United States?

Second, what characteristics would a wholesale electric power market have with regard to risk in order to provide reliable, least cost electric power to utilities and their customers?

Third, do existing power sales contracts appropriately allocate costs, risks and rewards?

Fourth, can the electric power industry and its regulators address shortcomings in the way risks are allocated, priced, and rewarded?

## INDEPENDENT POWER AS A UTILITY SUPPLY OPTION

Every region of the United States will need new electric generation capacity before 2000. The cumulative need for additional capacity between now and 2000, including replacement of obsolete plants, will range from 110,000 MW and 150,000 MW, depending on how quickly demand for electricity grows. The independent, or non-utility, segment of the power industry is already competing to supply a large portion of this demand, primarily with PURPA Qualifying Facilities.

The total installed electric generating capacity in the United States presently approaches 700,000 MW, of which independent generators now account for more than 26,000 MW, or almost 4 percent. New generating capacity under construction or advanced development is 69,000 MW, of which independents account for 30,500 MW or 44 percent. Several recent studies conclude that independent power producers could supply half of the additional generating capacity the United States will need by 2000. If this occurs, independent producers will represent about 12 percent of total U.S. generating capacity by 2000.

The independent power industry has evolved continuously since Congress passed PURPA in 1978. During the first decade of the industry, independent producers and utilities typically entered into power contracts with prices based on administratively-determined estimates of utilities' "avoided costs" of building and operating new power plants. Independent producers principally "competed" against projections of utility avoided costs. Price competition among non-utility generators was very limited (though competition for plant sites and financing did exist).

Today, independent power companies compete among themselves, as well as against utility proxies, in order to obtain utility power contracts. Utilities have awarded contracts for 12,960 MW of capacity in competitive bidding since 1986. Independent producers have won more than 80 percent of these bids, with utilities and demand side proposals winning the remainder. A total of 25 states have initiated proceedings or established procedures to include competitive bidding as an integral part of developing new electric generating capacity. Many of these procedures evaluate multiple attributes of the projects proposed: price; reliability; fuel diversity; risk allocation; and environmental impacts.

The record of competitive bidding to date suggests considerable success at attracting many parties willing to bid aggressively. Since 1989, bids to supply utility capacity have exceeded capacity

requests by a factor of roughly ten to one. This demonstrates how actively market participants are competing to supply utility needs for new electric generating capacity.

Under PURPA, QF's are exempt from compliance with PUHCA. This exemption made possible the initial development of independent power. But the standards for the QF exemption are now artificially restricting choice of fuels, plant site and ownership structure.

Creation of "Exempt Wholesale Generators" through PUHCA reform will increase the technology and ownership options that independent producers can utilize to meet the needs of their wholesale utility customers. Such reform is now essential if we are to evolve from monopolized to competitive power generation markets in the United States. It will not mean the end of cogeneration or renewable technology. It will mean that these technologies will be used where they are the most competitive in terms of price, reliability, and environmental impact.

#### RISK ALLOCATION IN ELECTRIC POWER SUPPLY TRANSACTIONS

The emergence of an independent power industry has provided electric utilities with a new power supply option. Rather than developing, financing, constructing, owning and operating the power plants which produce the electricity they transmit and sell to retail customers, utilities are able to buy it from independent firms. These independent power companies compete against each other for the right to supply utilities with a part of their power requirements. Thus, utilities now have a choice between producing themselves or buying in a competitive wholesale market the power they sell to their millions of retail customers.

When a utility produces itself the power it sells at retail, it assumes a variety of risks related to generating plant ownership. The utility and its regulators allocate these risks among equipment and service suppliers, customers, and investors. When a utility buys wholesale power from an independent producer, the utility and independent power producer agree on the appropriate allocation of risks between the independent producer and the utility. The independent producer and purchasing utility then absorb or pass on various risks they have agreed to assume. This agreement is embodied in the contract for purchase and sale of power. When power is purchased from a competitive wholesale market, the allocation of risk, as well as the price, is determined by market conditions at the time the parties enter into the transaction coupled with competitive procurement procedures adopted by state regulators.

Whether a utility proposes to generate power itself or buy it from an independent supplier, the state regulatory commission and FERC generally share authority to oversee the transaction, including determination of need for power, pricing and risk allocation. Most of the regulatory authority for this purpose resides in state commissions. Finally, it is important to note that there is, and will always be, wide variation in the terms and conditions in contracts for the purchase and sale of wholesale power. This variation will be due to specific generating plant characteristics and market conditions, as well as utility buyer and independent supplier preferences and the policies of relevant regulatory agencies.

In light of the above, the following is a discussion in general terms of the major risks of power generation. The discussion compares the allocation of various risks between the independent producer, the utility's customers and the utility's shareholders, depending on whether the utility produces or buys the power it sells to its retail customers.

The conclusions which emerge from the discussion are: (1) that electric utilities and independent power producers are sophisticated buyers and sellers engaged in complex transactions; (2) that the power contracts they negotiate shift substantial risks related to power plant project development, construction, operation and finance from utility customers and shareholders to independent producers; (3) that risks remaining with utilities are generally appropriate, in particular the retail market risk of utility customer electricity demand; and (4) that, overall, contracts for the purchase and sale of electricity in a competitive wholesale power market result in an efficient and equitable allocation of risk between utility customers, utility shareholders, and independent power producers.

### General Principles

Power sales agreements should have three general characteristics related to risk in order to ensure development of electric supplies on a least cost basis from the viewpoint of American consumers.

First, parties which bear risk should have an opportunity to receive compensation. Risk increases financing costs for utility or independent power investors. Without the opportunity to receive compensation for risk, the utility or independent power producer's ability to attract capital will erode. When customers bear a risk, they should expect to pay lower prices than if they had to compensate investors for absorbing that risk.

Second, parties which create costs should bear those costs in order to ensure that investment capital flows to the most efficient producers. This includes the impact of risk on financing costs.

Third, contracts should assign risk to the party best able to manage that risk. This ensures that there are incentives for managers to reduce the likelihood and consequences of adverse events.

### Development Risk

The successful development of a power project involves several complicated activities: screening technologies and sites; preparing and being awarded a competitive bid, in the case of an independent, or obtaining a utility commission certificate of need, in the case of a utility; obtaining a site; obtaining environmental and construction permits; negotiating agreements for fuel supply, fuel transportation, equipment, construction, and operating services. The costs incurred during project development vary widely, but they typically total several million dollars

before project construction begins. The cost, time, and eventual success of developing a project are highly uncertain.

Under traditional utility regulation, a utility's investors and customers share these risks. Utilities recover most planning costs as operating expenses, but may not be allowed to charge customers all costs of developing individual projects which are subsequently abandoned. For instance, in California, utilities can recover from customers the direct costs of abandoned projects, but do not recover financing costs.

Power contracts shift project development risks from utility customers and investors to independent power producers. An independent power producer entirely bears development cost risk for its projects. The independent producer must completely write off the cost of projects which do not reach financial closing. Utility customers and investors may continue to incur some development risk as long as the utility develops "backstop" plans for power plants; however, their overall exposure to development risk is minimal.

### Construction Cost Risk

Construction costs range from tens to hundreds of millions of dollars (billions of dollars for large coal or nuclear plants). Many factors can change construction costs and periods: changing inflation or interest rates; changing environmental or safety regulations; equipment supply disruptions; inadequate scheduling and cost controls.

Under traditional utility regulation, utility customers and investors share the risk that a new power plant will be completed at the estimated cost. Generally, utility investors only face the risk that management would not do a competent, "prudent" job of managing construction. Regulators would disallow "imprudent" costs from rates, but customers bear all other construction cost risk. Today, some state regulators have indicated that they will strictly enforce caps on construction costs that utilities may recover from customers -- without regard to the reason for the cost overrun. Moreover, utility investors generally face a "heads we lose, tails you win" situation in which regulators punish poor management by disallowing costs, but provide no greater reward for excellent management than for merely competent management.

Power contracts clearly shift construction cost risks from utility customers and investors to independent power producers. The utility contracts to purchase capacity at a set price. The independent power producer must control construction costs. Utility investors no longer face the risk of prudence reviews or caps for construction costs. Utility customers do not face rate shock stemming from cost overruns, though they forego the opportunity to benefit from projects which are completed under budget.

Independent power producers and their contractors bear the risks and receive the rewards of controlling construction costs. An independent producer which reduces construction costs by a

dollar from that assumed in arriving at the prices agreed in the power contract reaps a dollar of reward (and loses dollar-for-dollar if there is an overrun).

### Project Completion Risk

The long lead times and uncertainty of success of efforts to construct power plants creates uncertainty regarding timeliness of, and eventual completion of projects. Failure to develop and construct a project on schedule may cause a utility to purchase capacity and energy at a higher cost. In the extreme case of a project becoming economically unviable, a utility might have to construct an alternative resource on an expedited basis.

When a utility constructs and owns a new power plant, utility customers and investors share this risk in the same manner as they share development and construction cost risks.

Power sales agreements substantially, but not completely, shift risk from utilities to independent power producers, and thereby create very strong performance incentives. Power contracts include incentives such as project schedule milestones, deposits, and performance bonds. The independent power producer risks forfeit of deposits and power contract cancellation with no recovery of its costs if it does not perform. Also, the independent power producer has capital at risk throughout development and construction. Lenders usually require equity investors in a project financing to place all of their eventual equity commitment at risk from the start of construction. The construction contractor places its capital at risk by providing a fixed-price contract and substantial liquidated damages in case of delays or deficiencies in plant performance. These contractual arrangements create strong incentives for the independent power producer to perform.

They do not, however, completely relieve utility investors and customers of project completion risk. The utility still has some risk, particularly during the period between entering into the power contract and the beginning of construction. The independent power producer may not be able to secure all permits, contracts or financing necessary to construct and operate a plant. The utility may have to contract with another independent power producer on less favorable terms, or build its own facility on an expedited basis in order to meet its obligation to serve customers.

The impact of project completion risk in such a case depends upon the size of the power plant in relation to the utility's resource base. Independent power producers generally have built smaller scale power projects than utilities. The "residual" completion risk which a utility faces from a diverse group of small projects is much lower than for a single large project, even if any one small project is more likely to fail. Utilities can account for any residual completion risk in their resource modelling and contract negotiations.

### Financial Price Risk

Financial price risk is uncertainty about the future value of an investment due to changes in interest rates, equity investors' required rates of return, and tax policies.

Under traditional utility regulation, utility customers and investors share financial price risk. Regulators allow utilities to adjust customer rates periodically to reflect changes in interest rates, equity investors' required returns, and income taxes. These adjustments are intended to provide the utility sufficient profits (but no more) to attract investment capital to meet its obligation to serve customers.

Power contracts shift virtually all of this risk for a power plant investment to independent power producers. When the independent power producer achieves financial closing, it has committed equity funding and creditors have committed loans. After construction, capital requirements for an individual plant are very low, and typically are internally funded. The independent power investor subsequently bears greater financial price risk but can also profit from lower financial prices.

These risks are very unlikely to affect the operating reliability of the project and its value to the utility. Even in an extreme case of project bankruptcy (discussed in greater depth below), the project's creditors have an interest in maintaining reliable operations. The only significant exposure for the utility is the period between entering into the power contract and financial closing. At that time, increasing financial prices could affect project completion.

### Fuel Cost Risk

Fuel costs comprise a significant portion of the total cost of generating electricity for most technologies. Fuel cost risk has four elements: marketability (fuel cost's relationship to market prices); stability (the level of volatility); dispatchability; and, for utilities, regulatory cost recovery.

State regulation varies considerably in treatment of fuel cost recovery and risk for utilities. Many state regulators have provided special "fuel cost adjustment accounts" to enable utilities to incorporate a large portion of unexpected changes in fuel costs in customer rates during subsequent years. These "adjustment accounts" or "balancing accounts" became common during the 1970's as energy price volatility increased. Regulators reasoned that utilities often have little control over fuel costs, which may be driven by world oil prices or weather variations. Adjustment accounts shift most direct fuel cost risks to utility customers in return for moderating financial risk to utility investors, and, thereby, reducing the financing costs that utilities may pass on to customers.

Power contracts vary considerably in treatment of energy prices, which affects the fuel cost risk that independent power producers undertake. Most independents try to negotiate energy price



escalators which correlate with their own fuel costs, such as the cost of fuel at a similar utility plant. Even in this instance, the independent is exposed to changes in the relationship between power contract energy prices and its actual fuel costs.

Power contracts also have varied impacts on a utility's fuel risk. PG&E's experience with its "Standard Offer" power purchase agreements provides several lessons. PG&E has 1,700 MWs of "Interim Standard Offer No. 4" power purchase agreements with fixed electric energy prices which were set in the mid-1980s, before oil and natural gas prices collapsed. Consequently, PG&E is paying very high prices for some of the energy it is now purchasing from QFs. On the other hand, California "Standard Offer Nos. 1, 2, and 3" contracts provide energy prices which fluctuate with PG&E's marginal fuel costs. Although this means higher fuel cost volatility, energy prices charged to the utility and passed on to its customers generally track market costs.

Power contracts with dispatch or curtailment rights also enable a utility to shift fuel cost risk back to the independent power producer. With dispatch rights, the utility can temporarily shut down the independent power plant if less expensive sources of energy are available. More and more utilities are valuing dispatch or minimum curtailment rights in competitive bidding for power contracts. This enables the utility to manage the overall power supply system most efficiently.

The net effect of fuel costs on utility customer, utility investor, and independent power producer risk profiles depends upon regulatory treatment and power contract terms. The trend in new power contracts is to dispatch energy production, based on prices tied to variable production costs and indexed to a utility or market fuel cost index. This subjects utility customers to fuel price volatility, but enables the utility to reduce the overall level of fuel costs through economic dispatch.

#### Non-Fuel Operating Cost Risk

Non-fuel operating costs, such as labor for operations and maintenance, replacement parts, property taxes, and insurance comprise a small part of total power plant costs.

Under traditional utility regulation, regulators authorize utilities to adjust their rates periodically to reflect changes in costs. Utility investors bear the risk that costs will escalate very quickly between rate cases, leading to "attrition" in utility profits.

With power contracts, independent power producers and their contractors entirely bear this risk. Independents' actual operating costs are decoupled from the price charged utilities for capacity or energy. Utility customers and investors forego the "upside" opportunity of benefitting from lower than expected operating costs in return for the more stable prices established in the power purchase contract.

### Reliability Risk

Reliability risk is the uncertainty that the power plant will be available for energy production as anticipated. The level of reliability risk will vary with the type of technology employed, employee skill and power plant size. Utility planners incorporate this risk in estimating required "reserve margins", the amount of generating capacity above expected demand levels necessary to ensure system reliability. If a plant has lower availability than anticipated, the utility may need to procure additional capacity and energy from other sources. If a plant closes prematurely the utility may even have to construct another resource on an expedited basis.

Under traditional regulation, utility customers and utility investors share reliability risk. Customers bear the brunt of reliability risk when the utility owns the power plant. However, utility investors face the risk that lower reliability is the consequence of management mistakes, and that regulators will not allow the utility to pass higher energy or capital costs on to customers. Regulators may even remove an entire plant from utility ratebase (the assets on which the utility earns a profit). But these are extreme cases.

Power contracts shift most of this risk, and provide very strong performance incentives, to the independent power producer. Most contracts being signed today set strict availability levels for the independent producer. If availability falls below specified levels, capacity payments fall. Also, many independent producers have performance incentives in contracts with operating and maintenance contractors. If the plant's availability declines, the operator makes no profit. Also the relatively small size of most independent facilities mitigates the impact on the utility system of unreliable operation at any one plant, as described above.

Utility customers still retain two significant risks. First, replacement power may be more expensive than in the original power contract. Second, in cases where a project is no longer economically viable, customers may have already paid for capacity and energy at prices above market during the early years of the contract, but do not receive the value of below market prices later in the life of the contract. Even here, the relative economic risk to utility customers appears to be no greater than that for a utility plant.

Utility investors also retain some risk because the utility is the supplier of last resort, with an obligation to serve retail customers. Standard and Poor's has suggested that utilities with significant purchases from independent producers maintain slightly higher reserve margins than they would otherwise. If performance incentives are weak, or if the independent uses unproven technology, utilities may need to maintain higher reserve margins, though the diversity and smaller size of most independent power projects can mitigate this risk. Utilities can accommodate these costs and benefits in resource planning, competitive bidding procedures and contract negotiations with independents.

### Demand Risk

Demand risk is the uncertainty that, when a power plant is completed, the utility will need the additional generating capacity in order to meet demand for electricity from its retail customers. Whether the utility builds new capacity or buys it, this risk usually stays with utility customers and investors.

Utilities and independent power producers require a high degree of assurance that a market for a power plant's electricity will exist when a plant is constructed. A power plant takes years to plan and construct. It involves a significant, immobile capital investment which can only serve local and regional markets. Without a high degree of assurance that a market will exist, investors will not provide investment capital needed to build electric generation capacity. Utilities secure that assurance by having a regulated retail distribution franchise. Independent power producers secure that assurance by having a power contract with the utility. The utility and its regulators, in turn, must absorb or allocate that demand risk just as if it had built the power plant. Thus power sales contracts do not reduce demand risk to utility customers or investors.

Utility customers bear the bulk of, but not all, demand risk. If a utility exceeds capacity required to provide reliable service, within a wide margin, customers will carry the added costs. If the utility has capacity considerably in excess of demand, however, regulators may temporarily "disallow" excess all or some portion of capacity costs from rates under the guise of poor management planning, whether the utility owns or buys the capacity. Factors such as conservation incentives and resource planning may also affect risk allocation. For example, utilities can not face significant demand risk and simultaneously promote energy conservation (California energy utilities have sales volume adjustment accounts to preserve conservation incentives). Likewise, utility investors should not be held accountable for resource decisions made through a regulatory process, not by utility management.

Allocating demand risk away from independent power producers is generally appropriate. The utility, not the independent, controls distribution to retail customers, controls customer marketing, has significant influence over rate design, and controls access to the transmission grid. Because of its role in distributing electricity, the utility is in the strongest position to anticipate and respond to needs of retail electricity customers. It makes no sense to allocate significant demand risk to independents if they do not have access to retail or alternative wholesale markets.

The residual demand risk which utility investors still bear is an indirect cost of power contracts. It will increase utility financing costs when the capital markets recognize that risk. The impact on utility financing costs, in turn, will increase customer rates, and should be recognized as an indirect cost when evaluating power contracts.

## INDEPENDENT POWER PROJECT FINANCING

Some analysts have argued that high leverage used in independent power project financing demonstrates that independents shift significant risk to utilities through power contracts and create risk for electric reliability. This argument ignores the role of reliability in capital structure policy, and significant differences between utility corporate financing and independent power project financing.

Three factors are considered in setting the proportions of debt and equity in a firm's capital structure: the basic risk of operations (as measured by the volatility of the firm's pre-tax operating income); the firm's ability to reduce its income taxes by deducting interest payments; and the potential cost to the firm of entering or coming close to bankruptcy. This generally accepted model predicts that firms will increase borrowing in order to reduce income taxes as long as the risks and costs of bankruptcy remain small. As operating income becomes more volatile, a business increases its exposure to bankruptcy for a given level of debt. One would expect a high borrowing level to accompany low operating risk. However, the cost of "financial distress" (bankruptcy or operating with a high risk of bankruptcy) also varies considerably across industries and organizations.

Financial distress has direct costs such as legal fees of bankruptcy or suppliers' reluctance to advance trade credit. It also imposes indirect, opportunity costs if a company must forego investments because investors will be reluctant to supply new capital. This consideration is extremely important for a utility because it has a legal "obligation to serve" all of its customers in return for having a monopoly retail franchise.

The obligation to serve requires a utility to maintain a more conservative financial profile and capital structure policy than its underlying business risk would otherwise indicate. Consequently, a utility generally maintains a reserve of borrowing capacity. If a natural disaster occurs, the utility must restore service quickly, necessitating large capital expenditures on short notice. If a utility had the option to turn away new customers, it probably would use a more highly leveraged capital structures to reduce its direct financing costs.

An independent power producer with a project-financed power plant has contractual obligations to maintain the reliability of a single power plant, not an integrated utility system. The independent is not committed to building another power plant to meet load growth. It is not required to connect new retail customers or expand the capacity of the transmission grid. It must, however, set aside cash reserves and have sufficient cash flow to maintain the plant and fund capital improvements. Independent power projects have a high tolerance for leverage largely because they do not need the flexibility to invest large sums of cash after construction is completed.

Independent power project financing differs from utility corporate financing in several other ways which affect relative borrowing levels:

First, in project financing, potential lenders scrutinize all aspects of the proposed power plant's design, construction and operation in order to assess risk prior to advancing funds or other credit support. Lenders use their own independent engineers to review plans, construction quality, and operating procedures. Lenders in a project financing virtually become financial partners. Potential utility bondholders, on the other hand, can review disclosures required by the Securities and Exchange Commission as well as published reports of bond rating agencies. But utility bondholders are not in a position to perform an exhaustive scenario analysis to understand a company's economics.

Second, project financing lenders' sophisticated and enhanced information enables them to tailor lending terms to the project. Lenders and their expert advisors impose and enforce covenants which may require cash reserves, review of construction and maintenance budgets, restrictions on distributions to equity investors, and even contingent commitments for equity investors to infuse additional cash. Utility bonds also have covenants, but they necessarily relate to the general financial and operational conditions of an integrated utility.

Third, project-financing arrangements specify sources of contingent equity which cushion the project against certain adverse events, and effectively increase the level of equity at risk above 20 percent of the project's total capital cost. The largest source of contingent equity is the construction contractor, who typically covers most direct cost overruns with a fixed price contract, and who will cover potential delay or performance shortfalls by providing liquidated damages. Liquidated damages provisions may equal 20 to 30 percent of the project cost.

Fourth, project-financing arrangements for independent power projects steadily reduce their debt leverage over time, as the plant operates, whereas utilities maintain their debt leverage over time. Independent power projects typically begin operations with an 80 percent debt ratio compared with utility ratios of just over 50 percent. But independents pay off their debt within 10-20 years. During this 10-20 year period, the weighted average debt ratio approximates 70 percent. After the first ten years, independents expect equity ratios to approach 30 percent.

Fifth, utility equity ratios provide somewhat less financial flexibility than meets the eye due to preferred and common dividend payout expectations of utility shareholders. This also reduces the effective difference between utility and independent power project capital structures. In theory, a utility manager may reduce common and preferred equity dividend payments. But a utility manager rightly views cutting dividends as a step to be taken only as a last resort. Indeed, a utility manager focuses attention on finding ways to support dividend increases, knowing that the price of a utility stock is based largely on expectations regarding dividend yields. So dividends take on the attributes of a fixed cost. Utility bond rating agencies recognize that dividend payouts increase reliance on capital markets to fund new investment, decreasing a utilities' financial flexibility. For example, one of the "benchmark" financial ratios used by Standard and Poor's to evaluate utility credit quality compares cash flow after dividend payments to capital expenditures. These considerations considerably reduce the difference between utility and independent power capital structures.

Electric utilities on average have common equity ratios of just over 40 percent, and pay out approximately 80 percent of earnings as dividends. Independent power projects have no fixed dividend payments and their creditors impose limits on cash distributions.

The differences described above account for much of the difference between utility and independent power project financing. The fact remains, however, that an independent power project takes on substantially greater debt and has a much lower level of financial flexibility than a financially healthy utility. Will this reduce the reliability of electric service from an independent producer?

In a few cases, most likely when using unproven technology, an independent power project may become uneconomic and shut down. In these cases, utilities (most likely utility customers) will bear a risk of finding replacement capacity and energy at the same price.

In other instances, independents may structure operating contracts or financing unwisely so that revenues do not cover all costs, even though the plant is operating reliably. In this case, independent power project bankruptcy or threat of bankruptcy is not likely to substantially affect plant operations, the purchasing utility, or its customers. The strategy of project creditors in bankruptcy will emphasize continuing plant operations while restructuring liabilities and management. Operators will keep their jobs and the plant will continue to generate electricity. Creditors and equity investors must recarve a smaller pie.

#### **RISK ALLOCATION, "RISK SHIFTING", AND "RESIDUAL RISK"**

Opponents of PUHCA reform have asserted that independent power producers will earn "excess profits", and will divert investment capital from utilities. This remarkable assertion contradicts basic economic principles. Systematic profits above the level required to compensate investors for risk quickly attract new entrants, capital investment and competition, which then drives down profits. An excess profit scenario could occur only if substantial competition did not exist. The success of competitive bidding in several jurisdictions belies this argument. Systematic excess profits could occur if utilities are compelled to pay independent producers an administratively determined avoided cost without competitive bidding or negotiation with the utility. Creating EWGs through PUHCA reform as new species of independent power producer does not compel utilities to purchase their power and does not set a standard for payments based upon utility avoided costs, however determined. Rather, EWGs will enhance competition in wholesale power markets.

A key question is whether utility customers and investors receive compensation for any risks they continue to bear under power purchase agreements. As compared to the risks if a utility were to undertake a generation project itself, the total level of risk that utility customers and investors bear decreases because the independent power investors have assumed significant risks. However, the level of risk relative to the utility's asset base has increased since the utility retains

some residual risks not shifted by the power contract, while the utility will not add an earning asset in the form of a power plant.

The capital markets will eventually incorporate these risks in higher required rates of return on a utility's debt and equity securities. Depending upon contract terms and the utility's degree of reliance on purchased power, the increase may be insignificant or quite substantial.

Credit rating agencies and some utility analysts have proposed evaluating the impact of power contracts on the purchasing utility by drawing an analogy to debt financing. Capacity payments (and, in some instances, fixed energy payments) would be analogous to utility debt payments if prices do not vary with actual demand and energy costs. In effect, the utility has substituted contractual, "operating leverage" for financial leverage capitalized on its balance sheet. The contracts effectively increase the utility's debt ratio and risk for its creditors and equity investors.

Some type of operating leverage approach will be appropriate in most circumstances. However, capacity payments to independent power producers power are not equivalent to utility debt payments. If a utility borrows funds to construct a power plant, it must repay the funds even if the plant is not constructed, the capacity is not required to meet demand, or the plant operates unreliably and shuts down. No utility would agree to such a power purchase contract with an independent power producer. Power purchase contracts only allocate the retail market demand risk, some portion of fuel risk, and minor project completion and reliability risks to utility customers, and investors. The independent producer absorbs substantially all the other risks. It seems particularly odd to argue, as some have, that payments to independent power producers are risky because they are highly certain fixed costs, yet also risky because they are unreliable and uncertain! One can conclude that fixed capacity payments to independent power producers effectively increase utility operating leverage, but less than a dollar-for-dollar amount.

The relationship between power purchase contract capacity payments and utility debt leverage will depend upon individual contracts, and must be resolved among utilities, independent power producers, and regulators. PG&E will be evaluating this issue in greater depth as part of its resource and financial planning efforts. Today, we can conclude that there is some impact.

#### ADDRESSING SHORTCOMINGS IN RISK ALLOCATION

Utility managers and regulators have several approaches to ensure that utility investors are compensated for the "residual" risks of power purchase contracts, and that the cost of that risk is incorporated in resource planning.

First, a utility may adjust its common equity ratio to offset any operating leverage from power purchase contracts. Regulators would need to authorize adjusted ratios for setting rates of return on the utility's rate-based assets. A utility probably will also need to add this cost in determining the full cost of power contracts for purposes of comparison with the costs and risks of building and operating a power plant. This approach has the advantage of stabilizing the utility's level

of credit risk (measured by its bond rating), and maintaining its former level of financial flexibility.

Second, a utility may accept the higher level of risk and reduced financial flexibility, but ask regulators to authorize higher rates of return to compensate stockholders. Again, the difference in costs usually should be reflected in evaluating power purchase contracts. This approach could happen by default over time as prices for utility securities incorporate the higher risk relative to the smaller asset base the utility will have as a result of purchasing power. Adjusting rates of return after the fact, however, would not ensure that the utility had made least cost generation procurement decisions for its customers. (Prior to adjusting returns for a utility in such circumstances, regulators should also consider how existing returns may have reflected expectations that the utility would build or purchase generation resources.)

Third, regulators may permit a utility to include a small profit margin on power purchases. This has the advantage of providing utilities an incentive to shift a portion of the risks that customers bear under traditional regulation to independent power investors as well as making utilities financially indifferent to purchasing versus building.

Fourth, utility and independent power managers may be able to negotiate additional contract provisions which shift even more risk to independent power investors, but compensate them equitably. For example, power purchase contracts could include buy-out options for different periods of the independent power project life. Such options could work in a manner similar to call options included in most corporate bonds. This would be particularly valuable insofar as it would enable the utility to reduce the potential consequences of the retail market demand risk it bears. PG&E has negotiated deferral agreements for several QF projects in its service area to time capacity additions more closely to demand growth. An option pricing mechanism would formalize this process up front when contracts are first awarded in order to simplify negotiations later.

Finally, the utility and its regulators can continue to value contract features such as dispatchability which provide performance incentives and reduce customer and utility risk.

## CONCLUSION

Denying the EWG supply option to electric utilities and independent power producers is not a strategy aimed at providing least cost electric supplies. Creating the EWG option, fostering competition, and recognizing the total costs of all purchased power contracts and utility-owned power plants will provide such supplies. The risk issues raised by opponents of PUHCA reform are appropriately handled in contract negotiations between wholesale electricity buyers and sellers. These risk issues are being effectively addressed in power transactions between utilities and independent power producers, and they do not warrant delay of PUHCA reform. This Committee, and the Congress should approve PUHCA reform expeditiously.



RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM  
Charles A. Patrizia

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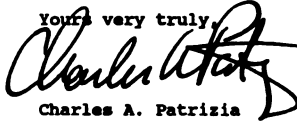
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The Honorable Christopher J. Dodd  
United States Senate  
Russell Senate Office Building  
Suite 444  
Washington, D.C. 20510

Dear Senator Dodd:

On September 17, 1991, I testified at the Securities Subcommittee hearing on behalf of the Registered Holding Companies. Attached are my responses to follow-up questions concerning transmission access, which were submitted by Senator Shelby for your information. If I can be of further assistance in clarifying my client's position, please let me know.

Yours very truly,



Charles A. Patrizia  
of PAUL, HASTINGS, JANOPSKY & WALKER

Enclosure

**Questions for Mr. Charles Patrizia**

From Senator Richard C. Shelby

Testifying on Behalf of the Registered Holding Companies  
Tuesday, September 17, 1991 Securities Subcommittee  
Senate Banking Committee.

Mr. Patrizia, I'm interested in the position your clients would have regarding the recent trend at the FERC that places 3rd party deals ahead of the local utilities needs to serve their customers. As I understand what's happening, utilities have traditionally used their transmission lines to buy power from their neighbors when it's cheaper than generating themselves. Also, utilities on occasion, for example when the weather is hotter than expected, will have to purchase emergency power from their neighbors. What the FERC is saying is that 3rd party deals are to be put ahead of these economy and emergency purchases that are for the benefit of the local customers.

- Q.1. If the FERC is clearly showing a disregard for the needs of the local customers, why should we give them any more authority over these matters?
- A.1. In recent decisions on the Pacific Power & Light and Northeast Utilities merger matters, FERC has appeared to favor third-party transactions over native load customers. The effect of the decision to give priority to "firm" transactions, is to force utilities, where transmission capacity may be limited, to maintain a firm transaction to the financial disadvantage of the native load customers, and in some cases to the detriment of reliable service to native load customers.

The registered companies, like all utilities, believe strongly that the interest of the native load customers must be placed above the financial interests of Firm third party transactions.

Transmission facilities are essential to the functioning of the integrated systems owned by registered companies. The registered companies in particular are required by the 1935 Act to interconnect their facilities and all of them operate on a centrally dispatched basis, pooling the generator capacity to assume that the native load of the operating companies is served by the lowest cost available supply, regardless of ownership arrangements. Thus, native load customers benefit from the investment utilities

have made in constructing the infrastructure which makes these arrangements possible.

Permitting third parties to gain access to the transmission facilities will harm native customers in two ways. First, if utilities are forced to "dedicate" a portion of their transmission capacity to third party transactions, this may displace transmission capacity that would otherwise be devoted to providing least cost available power to the native load customers. Thus, the utilities would be forced to operate the system to preserve third party transactions rather than economical efficiency for their customers. Second the proposals do not require third party transactions to pay the entire costs associated with third party transactions. These costs are far greater than the mere cost of using transmission lines and it includes indirect costs of replacing the capacity, and opportunity costs for transactions that would benefit native load.

Therefore, we do not believe that the trend to allow third party transactions to displace allocation decisions that are made within a power pool system benefits native load customers and it should be sharply curtailed.

- Q.2. Why do some interests want the FERC to have more authority?
- A.2. Clearly, other interests are pursuing greater authority to engage in third party transactions because they stand to realize economic gains from these transactions. However, these interests are not generally responsible to individual ratepayer or state regulatory commissions whose primary duty is the protection of the native load customers.

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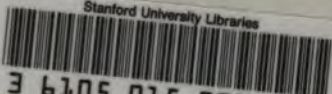
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